

# Taxation of Wealth and Wealth Transfers

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## DRAFT PAPER - NOT FOR QUOTING

### Contents

1. Introduction
2. The Meade Report
3. Principles – criteria for evaluating a tax system
4. The Tax Treatment of Wealth Transfers
5. The Tax Treatment of Wealth
6. Other taxes on wealth and wealth transfers
7. References
8. Appendix – current UK tax system.

## 1. Introduction

The case for taxing wealth and wealth transfers is one of the most vexing issues of tax policy, and its practice differs considerably among OECD countries. Several contentious issues arise including the following:

1. **Utilitarian arguments.** The most fundamental issue concerns the place of wealth transfer taxation in the broader system of taxation. The standard principle of tax design is that persons should be taxed based on how well off they are, which we can refer to as the utilitarian argument. This motivated many of the fundamental proposals in the *Meade Report*, and is the basis for much of the academic and policy literature on tax reform, including the concepts of horizontal and vertical equity. The utilitarian approach raises difficult conceptual issues in the case of taxing transfers of wealth. To the extent that wealth is transferred voluntarily, a given transfer could yield benefits (utility) simultaneously for the donor and the recipient. If tax liabilities are notionally based on the level of welfare of taxpayers, this would seem to suggest that a given transfer of wealth should trigger a tax liability on both the transferee and the transferor of such wealth. Suppose, for example, person A transfers £100,000 to person B. Assuming A does so voluntarily, this might be regarded as equivalent to spending on personal consumption. Thus, as with other forms of consumption A would obtain no

personal tax relief on account of the transfer: it would simply be a use of A's after-tax income for the purposes of obtaining utility. At the same time, the £100,000 received by B would be regarded as a source of income that can be used for his consumption purposes and taxed accordingly. Effectively, the transfer has been made taxable to both A and B. If B turns around and transfers the sum to someone else (e.g. an heir) without consuming it, it would be taxed yet again in the hands of person C, and so on. Is this consequence of the utilitarian logic desirable, or should the transferor be given relief for the transfer since they have not consumed it?

2. **The redistribution argument.** One of the arguments for imposing taxes on wealth and wealth transfers is to correct inequalities in the distribution of wealth and thereby promote equality of opportunity. It was the aim of achieving greater equality that led the Labour government in 1974 to produce a Green Paper on the introduction of a wealth tax in the UK stating "the government is committed to using the taxation system to promote greater social and economic equality. This requires a redistribution of wealth as well as income." However, the proposal was dropped and the degree to which wealth should be redistributed or even whether this is a desirable aim obviously remains politically contentious. In particular should inherited wealth be taxed differently from wealth acquired by the individual through his own effort and foregoing of consumption?
3. **Measuring and defining wealth.** It is difficult to predict the consequences of changes in the taxation of wealth because there is relatively little hard data about the distribution of wealth. It is said that the top 1% of the population owns around 20% of personal wealth but this depends upon how one defines wealth and the figures remain speculative. Moreover defining wealth itself is difficult. For example "human capital" i.e. the present value of the future earnings that an individual may earn is not easily measured and is not taxed (although obviously those earnings will be taxed when received). Similarly governments do not generally try to tax wealth held in the form of pension rights (although the income stream derived from taking the pension is taxed and recently the UK Government has tried to impose an inheritance tax charge on residual capital left on the death of the pension holder).
4. **Mobility of wealth.** Related to this are the practical difficulties of taxing wealth in a global world where both capital and people can move easily. Most countries impose some *situs* based wealth tax which applies tax on transfers of assets situated in that country. The UK imposes inheritance tax on transfers of property held directly by the individual (wherever resident or domiciled) if such property is situated in the UK. However such rules can easily be circumvented by the foreigner holding the UK property through offshore vehicles such as companies and then transferring the offshore company shares. Even if the capital value of assets situated in the UK is taxed on a recurrent basis e.g. by means of an annual wealth tax, irrespective of who owns the assets, most assets other than land can easily be moved to a jurisdiction where the tax rates are lower. It might be said that taxing real property periodically rather than transfers of such property is straightforward given the relatively immobile nature of land. However, even in

the case of land its taxable value can be devalued by use of debt.<sup>1</sup> Individuals have also become more mobile and may easily live in one jurisdiction while holding significant interests in another. The question arises as to whether one should tax their wealth on the basis of citizenship (as in the US), domicile (as in the UK) or residence (as in some European countries)? Foreign domiciliaries who live in the UK and hold significant wealth here, are currently subject to a very favourable tax regime.<sup>2</sup> Despite the apparent inequity there are good efficiency arguments for caution before changing the existing regime given the ease with which their wealth can be moved elsewhere.

5. **Relationship of donee to donor.** Should transfers of wealth be taxed at different rates depending on the relationship between donor (transferor) and donee (transferee) or the motive of the transferor? In some countries such as France, tax is levied at significantly higher rates on transfers to more distant relatives. In March 2006 the UK Government introduced a more adverse inheritance tax regime for those who make lifetime gifts to trusts as opposed to lifetime gifts to individuals on the basis that the donee should be allowed outright control of the gifted property. It is not clear why the controls placed on a gift by the donor (e.g., preventing a donee from accessing the capital until a certain age) should be of any interest to a government unless such controls through the use of trusts are a means of tax avoidance.<sup>3</sup>
6. **Donee vs donor based taxes.** Related to this, should transfers of wealth be taxed at lower rates if spread among more donees? This could be partially accomplished by a donor based tax – e.g. a donor is able to give up to a certain amount on death free of tax to each individual e.g. £100,000 irrespective of the wealth of that individual. Alternatively one could have a donee based tax, e.g. where the rate of tax on transfers of wealth would be governed not by the overall amount held in the donor's estate but by the history of inherited wealth for the donee. So each donee might have to pay tax to the extent transfers of wealth to him from any source exceed a certain limit over his lifetime. The UK has generally followed a donor based system of taxation which does not take into account the situation of the donee or the relationship borne to the donor or the notion that spreading wealth among more donees should be encouraged as a way of reducing the concentration of wealth.<sup>4</sup> Although capital transfer tax did for the

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<sup>1</sup> For example the foreigner can borrow from a company holding other assets situated abroad and charge the debt on the UK property. Or he can borrow from a bank with cash situated abroad offered as a back to back guarantee for the loan, hence reducing the costs of borrowing considerably. The UK property is then devalued by the loan.

<sup>2</sup> See Appendix

<sup>3</sup> The recent report by HMRC on the Taxation of Trusts concluded that tax was not a major reason for setting up trusts – rather it was the control that could be imposed on such wealth which was the motivating factor.

<sup>4</sup> Legacy duty and succession duty in 18<sup>th</sup> century Britain were charged at graduated rates depending on the relationship of the legatee to the deceased. The more remote the relationship the higher the rate of tax, - so redistribution was not a primary aim. In 1894 Sir William Harcourt introduced estate duty – a donor based tax levied at progressive rates on the value of the estate at death rather than the circumstances of the donee. In 1949 legacy duty and succession duty were abolished and the top rate of estate duty rose to 80%. Nevertheless redistribution of wealth remained limited. By the time estate duty was replaced with capital

first time in 1974 extend the taxation of estates to cover all lifetime gifts (not just those made within 7 years of death as in the last days of estate duty), it remained a donor based tax. So in general the relationship of the donee to the donor has had no effect on the rate of tax paid (with the exception of transfers to spouses and charities which are generally exempt). Is this acceptable? Whichever option is adopted the mobility of donor and donee needs to be considered as a matter of practical enforcement. For example if a donee based tax is adopted should the donee not pay any tax if he has no connection with the UK? If a donor based tax is retained should the taxation of the wealth transfer be based on the residence status of the donor?

7. **Taxing lifetime transfers differently from transfer on death.** Should transfers of wealth during lifetime be taxed at lesser rates than transfers on death? Different rates obviously encourage avoidance. Even under the capital transfer tax regime transfers of tax on lifetime gifts were taxed at less than the rate applying to transfers on death on the basis that it helped to ease the problems of the transfer of small private businesses. In any event by 1986 CTT was renamed inheritance tax (although it remains a tax on the donor's estate rather than a donee's inheritance) and lifetime gifts once again became wholly exempt from tax provided that the donor survived 7 years. (The current complex inheritance tax regime is described in the Appendix.) The taxman now favours "the healthy, wealthy and well-advised."<sup>5</sup> Does the current 7 year rule have any justification apart from a pragmatic attempt to deal with the problems of record keeping?
8. **Special reliefs.** Should certain assets qualify for special treatment either on transfer or on retention? The current inheritance tax regime broadly favours trading businesses as well as agricultural property. Hence transfers of such assets are often wholly exempt from tax even if the donee sells the relevant asset immediately after the death of the donor. The exemption is given on the basis that it is desirable to preserve such assets, but since the exemption is not conditional (ie the donee does not need to retain the asset after inheriting it), the validity of this point is questionable. Similar issues arise on the transfer of art. Many countries give special tax breaks to the transfer of fine art if the art remains in that country. Should different exemptions operate for the holding of such wealth as opposed to its transfer?
9. **Interraction with capital gains tax.** Should transfers of assets (whether on lifetime or on death) which show unrealised gains be subject to capital gains tax as well as transfer tax at the date of disposal by transferor? Or should the donee acquire those assets at market value or should he acquire the assets at base cost for capital gains tax purposes? Currently the UK system adopts a mixture of all these depending on whether the gift is a lifetime transfer and whether the recipient is a trust or an individual.

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transfer tax in 1974 it contributed only 2.4% of tax revenue – mainly because the tax could easily be avoided by making lifetime gifts.

<sup>5</sup> Kay and King (1990), page 107

10. **Non-monetary benefits.** It has been argued, as did, the *Meade Report*, that wealth is a suitable target for taxation per se. The argument is based on the notion that in some ill-defined sense wealth confers advantages on its owners that affect their well-being over and above the income that it can generate. So it is not just that a wealthy man can enjoy a higher standard of living (which would be an argument for a tax on expenditure) but that wealth itself confers non-monetary benefits, such as prestige, power, influence, independence, and so on. However, it is not easy to relate these non-monetary benefits to a monetary evaluation of wealth.
11. **Equity.** The horizontal equity argument for capital taxation often states that people in similar situations should be treated in a similar way e.g. an individual earning £100,000 should be taxed no differently from an individual who realises capital gains of £100,000. However, this point can be dealt with simply by taxing capital income and is not an argument for taxing the holding or transfer of capital wealth itself. The vertical equity argument is that individuals in unequal situations should be treated differently and this relates to the idea mentioned above that the ownership of wealth increases security and brings status and power which should be taxed. The argument that wealth in itself should be taxed might be magnified to the extent that increases in wealth are perceived to be windfall gains that have not required the sacrifice of forgone consumption or work effort. So on that basis inherited wealth would be taxed more than wealth which has been earned by the individual – although in practice taxing the two differently raises practical difficulties unless dealt with by an effective wealth transfer system.
12. **Taxing untaxed assets.** Another motive for taxing some forms of wealth periodically is that it serves as a proxy for taxing capital income (i.e. profits from capital) where the latter is hard to measure or monitor. Examples of owner-occupied housing or assets held abroad come to mind. Of course, this assumes that one wants to tax capital income on a comprehensive basis, given that in principle capital income includes not just the returns to financial assets (interest, dividends, capital gains), personal business income and royalties which are already taxed, but also the imputed rent on owner-occupied housing, pension savings and even the imputed return on human capital accumulation which typically are not taxed. Yet another argument for taxing real property periodically might be that this form of taxation is deemed to be a suitable revenue-raising instrument for local governments due to the relatively immobile nature of the tax base. And as noted above, taxing real property periodically might be one way around the problems of taxing the very substantial wealth held by foreigners in the UK.
13. **Charitable donations.** Some wealth is transferred not to persons but to charitable or non-profit organisations. The donees will obviously not be liable for tax, but how should the donors be treated? Arguments for providing tax incentives include the fact that such donations may have provide external benefits to third parties who may obtain altruistic satisfaction from the good that is perceived to be accomplished. As well, charitable donations may absolve the government from using its own tax revenues to support the work of charitable organizations.

14. **Taxing asset transactions.** Finally, governments, including in the UK often impose a tax on sales of assets like real property or company shares. The rationale for such taxes is not at all clear, although at one time they may have been a readily available source of revenues. They have the disadvantage of distorting asset transactions, but to the extent that the value of expected future taxes is capitalised into the value of the assets, eliminating them would give rise to revaluation effects that might be regarded as inequitable.

All this implies that the taxation of wealth and wealth transfers is fraught with conceptual difficulties, and that makes policy prescription unusually value-laden. The aim of this paper is to address some of these issues in the UK context and provide a reasonable basis for policy advice.

## 2. Some Context

We have discussed already the sort of issues that any discussion on the taxation of wealth and transfers of wealth needs to consider. The recommendations of the Meade Report are discussed below. The relevant features of the current UK tax system are summarized in the Appendix.

### Meade Report Recommendations

Along with its well-known advocacy of using consumption as a personal tax base, the *Meade Report* devotes considerable attention to wealth taxation and wealth transfer taxation, and makes relatively strong recommendations for both. With respect to wealth, the *Report* argues that it should be taxed in its own right since it confers ‘opportunity, security, social power, influence and independence’ (p. 40), and that the form of taxation should be on the wealth itself rather than, say, a surtax on investment income. So such a tax would be an annual one based on a taxpayer’s wealth from year to year. France has an annual wealth tax levied at rates of up to 3% although note that it is limited mainly to real estate where the owner is non-resident and is only charged on the net value of assets, so can be relatively easily circumvented by foreigners who simply charge the asset with debt.

In addition to this argument for a tax on wealth per se, the *Meade Report* argues that wealth transfers should bear taxation for both the donor and the recipient. That is, it discounts out of hand the notion that transfers of wealth constitute simple transfers of tax bases from one taxpayer to another, saying only that ‘there is a general consensus that gifts and bequests are a proper subject for tax’ (p. 41). This could be done within the direct tax system (either expenditure or income) by treating the donation as an act of consumption and taxable on the donor (i.e., not deductible from either tax base), and treating the receipt as an increase in the income of the donee for tax purposes and treated as such under expenditure or income taxation.

Alternatively, the *Report* states, one might not want to regard the transfer of income as simply being taxed both for the donors and the recipients under the direct tax system. The transfer itself might be believed to be a suitable base for taxation in its own right. ‘levied perhaps on a different principle (p. 41)’ (while not specifying what precisely that principle is, but later encouraging a more equal distribution of wealth and the desire to

treat inherited and accumulated wealth differently). In this case, the tax need not be progressively related to the direct tax base of either the donor or the donee (p. 42).

Based on these arguments, the *Report* outlines its preferred separate tax on wealth transfers, perhaps supplemented by a further annual or biennial tax on the wealth of the most wealthy to reduce large inequalities of wealth. It argues first that an accessions tax levied on donees is preferred to a tax based on the donor's bequest. An accessions tax can be designed to encourage the division of estates among more than one recipient, thus reducing the concentration of receipt of bequests. So for example instead of having one nil rate band per donor of £285,000 above which capital transfers are taxed at 40% on death, each donee would have a nil rate band of say £200,000 and receipts by the donee over this limit from whatever source would be taxed possibly at a more progressive rate. It can also target inherited wealth instead of all wealth, which includes that accumulated out of working and saving.

However, an accessions based tax has a number of problems. The *Meade Report* argued that a simple accessions tax could provide an incentive to postpone wealth transfers in order to postpone payment of tax, or to use trusts and other generation-skipping vehicles. The former may be less of a practical problem assuming that the rates of tax cannot be manipulated by the timing of transfers. So for example if a donee pays at graduated rates reaching say 40% on over £1m of receipts during the course of his lifetime, provided he keeps a record of all transfers he has received, postponing further transfers to him brings no rate advantage although it does postpone payment of the tax. However, as soon as 10 year cumulation periods etc are introduced then there is an incentive to manipulate the timing of such transfers.

A bigger practical problem for a donee based tax may be the use of vehicles such as trusts which can be for a wide range of beneficiaries. Unless one can link the trust to a specific beneficiary (so gifts to that trust would be treated as gifts to the individual beneficiary) it could be used as a vehicle of tax avoidance with donors making gifts to 10 separate trusts each with their own nil rate band as "donee". Either one ensures that the rate of tax on transfers to such trusts is relatively high – which is broadly the current regime in the UK on lifetime transfers<sup>6</sup> – or one limits such transfers to one trust per donor – although that then moves us back towards a donor based tax.

It is also true that an accessions based tax may be relatively easy to manipulate by use of minors and other 'peg life' persons as donees. It is also not clear how donees with no UK connection would be taxed if at all, despite the fact that assets might be situated in the UK or the donor might have been based here.

The record keeping of a "cradle to the grave" donee based accessions tax could also be awkward. In theory a donee could declare such gifts received during his lifetime from any source on his tax return and pay tax accordingly. In practice few donees submit annual tax returns under self-assessment so this would be a considerable extension of the current reporting requirements. Having said that, capital transfer tax imposed a reporting requirement on the donor in respect of all lifetime gifts so the idea is feasible. An accessions based tax also needs to consider the status of the donee – if he is non-UK

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<sup>6</sup> 20% as opposed to nil on gifts to individuals

resident how will the tax be enforced? Presumably there could be a withholding tax at a fixed rate on the donor and the donee would be left to make any repayment claim or pay any balance owing based on his actual cumulative totals. However, any transfer tax on lifetime gifts may not be collected easily where the gifted asset is illiquid.

The *Meade Report* proposes a Progressive Annual Wealth and Accessions Tax (PAWAT) to deal with some of these issues. The base of a PAWAT is the cumulative level of transfers received by a donee at any given time, net of any transfers made. The rate of tax on a given transfer also depends on the age at which the transfer is received: tax rates are higher the younger the age at which they are received. The actual tax rates are calculated on the principle that tax liabilities are equivalent to an annual tax on wealth held until a given age, say, 85. The idea is that the longer the inherited wealth is held, the greater the benefits conferred. The PAWAT thus has a number of perceived advantages: it is based on inherited and not total wealth; it is progressive and so encourages a more equal division of net transfers; and it captures the idea that wealth itself confers an advantage on a person. Of course, if the inherited wealth is not held until 85, the tax prepayment will have been excessive. Accounting for that makes the administration of the tax fairly complicated, and perhaps not easy to understand for the taxpayer.

To avoid some of these perceived disadvantages, the tax rate could be proportional rather than progressive, resulting in the Linear Annual Wealth and Accessions tax (LAWAT). The simplicity of this version is obtained at the expense of progressivity, which was deemed important to provide an incentive to divide up estates in order to reduce large inequalities of received bequests. To deal with this, the *Report* would combine the LAWAT at moderate rates with a progressive annual wealth tax with a fairly high threshold. This would also serve to bring into the wealth tax base accumulated wealth as well as inherited wealth.

Based on these considerations, the *Meade Report* proposes two alternatives to accompany an expenditure tax: the PAWAT by itself or the LAWAT combined with a progressive wealth tax with a moderately high threshold. Presumably, the same alternatives could be recommended even if a reformed personal income tax were retained as the preferred direct tax. The alternative of simply bringing all transfers received into the donee's tax base is not touted, presumably because that would not fully reflect the additional benefit that wealth is supposed to confer on households.

As a final note, it should be emphasised that the transfers discussed above refer to those made to heirs and other family members rather than to charities and non-profit organisations. Different principles might presumably apply to these, but what they should be is not taken up by the *Meade Report*.

We now turn to a broader consideration of the principles that might inform the design of wealth and wealth transfer taxes as a prelude to considering policy alternatives.

### 3. Principles: The Criteria for Evaluating a Tax System

In the end, choice of a tax system must be based on some principles. The opening discussion of the principles underlying wealth and wealth transfer taxes illustrates the difficulties involved in working out the correct principles. Moreover, they can involve

rather delicate value judgments. Since the *Report* was published, the literature on normative tax policy design has undergone a significant transformation. What follows is an attempt to capture some of the key features of that transformation as they bear on the issues at hand. We focus here mainly on the normative objectives of tax policy rather than constraints that make these objectives difficult to achieve, such as efficiency and administrative costs as well as political constraints.

It is useful to distinguish three categories of criteria that can underlie tax design. The first category is the traditional utilitarian criterion, also referred to as welfarism in the more formal literature. According to the utilitarian criterion, taxes paid by given taxpayers should be based on their relative levels of well-being (equivalently, welfare or utility). That is, how much tax should be paid depends on how well-off one is. The second set of criteria includes non-utilitarian criteria, where tax systems are judged according to other objectives that may not directly reflect individuals' welfare (except maybe in a long-run or indirect sense). The third category involves paternalistic criteria which may arise in circumstances where individuals may not be the best judge of their own interests (again except in some long run sense). Recognising these different criteria is especially important in the case of wealth and wealth transfer taxation.

## Utilitarian Criteria

The standard approach to normative tax analysis, typified by the optimal tax approach, takes as the objective of government a social welfare function, which is an analytical device for aggregating the utility or welfare levels of persons in the economy. This approach is based on the idea that what ultimately counts in assigning tax liabilities is the level of well-being taxpayers obtain. This approach also informs much of the policy literature, including the *Meade Report*, the *Blueprints for Basic Tax Reform* in the USA, and numerous comparable reports of other times and places. In the context of wealth taxation, the utilitarian approach has also been dominant (e.g., the recent surveys by Kaplow, 2001; and Cremer and Pestieau, 2006). According to the utilitarian approach, the tax base should be a measure that affects the taxpayer's well-being. Moreover, the rate structure should be based on judgments about how much equality in utility levels the society should strive for, at least conceptually. The choice of the actual tax base then reflects constraints involved with measurability, information, commitment, enforcement and administrative costs, while progressivity is constrained by incentives as well as concern about societal consensus.

Apart from the standard problems of measurement, interpersonal welfare judgments, and so on that make the application of the utilitarian criterion difficult, there are some more fundamental concerns that are especially relevant to the issue of wealth taxation. The first is whether all sources of individual utility should 'count' from a social point of view. If I dislike the colour of your house, or the books you read or the language you speak, should those be counted as reductions in my utility? Alternatively, if my utility is affected by how well off you are, either positively or negatively, should that count? This is clearly relevant for establishing the status of wealth transfers that are made voluntarily out of altruism or similar motives. Should the benefit of altruism count as utility for the purposes of tax policy? A related issue arises if my well-being is based on my position

relative to yours in terms of wealth, income, housing and so on. If so, increments in wealth have negative effects on others and, by utilitarian logic, ought to be taxed.

A more serious difficulty with utilitarianism involves dealing with persons who have different preferences. This makes it difficult to compare utility levels in principle, let alone in practice. Standard measures of welfare for tax purposes can lead to anomalous results. If otherwise identical persons have different preferences for leisure, for risk-taking or for saving, the tax system will typically treat them very differently. The correct treatment is not entirely obvious. In the theoretical redistribution literature, a distinction is made between the ‘principle of compensation’ and the ‘principle of responsibility’. (Roemer, 1998; and Fleurbaey and Maniquet, 2007) Persons ought to be compensated for disadvantages that they face that are beyond their control, as in the case of differences in innate ability stressed by the utilitarian optimal tax literature. However, they ought not to be compensated for differences arising from things for which they are responsible, an example of which might be their preferences. Applying this distinction in practice is fraught with difficulties – for example if some individuals are innately hard-working or lazy – but one approach that has been fruitful is to equalise opportunities that households have, regardless of how they choose to use them. This might be taken to be an argument for equalising, say, inherited wealth as an objective of policy over and above direct personal taxation based on outcomes. It might also be used to justify not taking special account of altruistic preferences. That is, if personal choice leads some persons, but not others, to leave bequests or to donate to charities, no distinction should be made in the tax system between the two types. Freely made choices to make transfers should not attract favourable or unfavourable tax treatment according to this point of view.

## Non-Utilitarian Criteria

Equality of opportunity may be regarded as a non-utilitarian criterion, although it is inspired by utilitarian concerns. In fact, equality of opportunity is often given explicit sanction in national constitutions, as well as in normal policy discourse. There are other objectives that also stray from strict utilitarianism. Some elements of social and economic rights might involve government provision of basic goods such as water, housing, health care and education independent of utilitarian calculation.

In the case of wealth taxation, as we have seen, the argument is made that wealth confers benefits to persons over and above the role of wealth as a source of consumption or income. It might confer status or power as well, or it might provide opportunities that are otherwise not available to other taxpayers. One has to be wary of double-counting here. To the extent that the benefits of holding wealth ultimately show up as income or consumption, they will then be subject to direct taxation. For wealth to be a separate base for taxation, one must be persuaded that it does provide benefits over and above those that confer utility, or that the benefits that confer utility do not otherwise end up being taxed. Indeed, it may well be that the forms of wealth that do confer extra benefits are those that cannot be easily taxed, such as human capital and other personal attributes.

It is probably fair to say that there is no discernible consensus among students of tax theory and policy that wealth should be regarded as conferring a benefit on its owners over and above its usefulness as a source of income or consumption. Despite that, the *Meade Report* simply assumed it to be the case. Since much of the argument for the

taxation of wealth – over and above the taxation of wealth transfers – rests on the assertion that wealth itself is a source of benefit, one cannot avoid taking a position on the matter. In the absence of convincing argument, one might be sceptical about basing arguments for major tax reform on such a premise.

## Paternalism

Recent literature on behavioural public economics has stressed various ways in which individual decision-making may lead to outcomes that are not in the long-run interest of the individuals themselves, and the puzzle this poses for government policy (Bernheim and Rangel, 2007). Three general categories of problems have been stressed. Persons may not be well enough informed to be able to take some types of decisions, such as those involving financial transactions. To reduce the costliness of such transactions, governments may impose regulations on suppliers or may mandate, or default, individuals into certain types of actions (health care, education, prescription drugs, etc.). Second, persons might purposely make choices against their own self-interest for reasons of ethics or social norms. Donating to charity might be an example of this. The fact that these actions are against their own self-interest may warrant favourable treatment under the tax system, although it may be impossible to detect the true reason for such donations. The merits of such a strategy will also depend on how the price elasticity of charitable donations compares to the deadweight cost of supporting those donations that would have taken place in the absence of the favourable treatment.

Finally, personal decisions might be subject to intertemporal inconsistency as a result of myopia, self-control problems or not anticipating the consequences of one's actions. This is said to lead to such outcomes as undersaving for retirement, addictions, excessive gambling and procrastination, to name a few. More generally, people may overestimate the satisfaction that they will enjoy as a result of acquiring consumer durables and other forms of wealth. Governments may react to such time-inconsistency problems by second-guessing personal decisions and purporting to correct them so that they align with long-term interests. Naturally, this paternalism is very contentious since it contradicts the usual norms of consumer sovereignty. In the context of wealth taxation, the most relevant feature of this behaviour is the possible tendency for undersaving, especially for one's retirement.<sup>7</sup> On that account, wealth taxation might be viewed as counterproductive to the extent that it discourages saving, although this will depend on the extent to which 'undersavers' (as opposed to those saving appropriately) respond to the financial incentives they face.

Given this background, we turn to the principal arguments for wealth and wealth transfer taxation. We begin with the case of wealth transfer taxation since it fits closely into the standard paradigm for choosing a direct tax system. The taxation of wealth will be then be considered, followed by other forms of taxation on wealth and wealth transactions. Where appropriate, we discuss the tax treatment of wealth and wealth transfers under the two competing candidates for direct taxation, expenditure taxation and income taxation.

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<sup>7</sup> Scholz, Seshadri and Khitatrakun (2006) find relatively little evidence of ex-post under saving in the US: only 18.6% of households are found to have lower than optimal savings, and amongst these the shortfall is relatively small (\$5,700 on average).

## 4. The Tax Treatment of Wealth Transfers

The issues surrounding the tax treatment of wealth transfers can best be revealed by considering the simple case in which one person, a donor, makes a voluntary transfer of funds to another person, the donee. We set aside for now the issue of whether there is a particular relationship between the two, focusing instead on the transfer in the abstract. If one takes a strict utilitarian approach to tax design (following, say, Kaplow, 2001), one would treat the transfer as yielding welfare to the donor, equivalent to any other consumption spending, since it was voluntarily undertaken. By the same token, the transfer is like an increase in income to the donee.

The tax implications are similar whether expenditure or income taxation is in effect. In the case of the former, the transfer is treated as an act of consumption by the donor so enters the tax base as such. For the donee, the transfer is a receipt of income, so it also enters the tax base unless it is used to purchase a registered asset. Under an income tax, again the transfer is like an act of consumption by the donor so obtains no tax relief. For the donee, the receipt is simply added to income. If the direct tax system is a hybrid one, matters are slightly more complicated. For example, a schedular approach might be adopted whereby earnings and asset income are subject to separate rates. The so-called dual income tax system in the Scandinavian countries is of this sort, whereby earnings are taxed progressively, while capital income is taxed at a low, fixed rate. This was also one of the options proposed in the USA by the President's Advisory Panel on Tax Reform (2005), which they referred to as the 'Growth and Investment Tax Plan'. The issue here is whether a transfer received by a donee should be treated as earnings or asset income. In actual dual income tax systems, transfers from government and pensions are generally included with earnings and taxed progressively, and that would seem appropriate for transfers received from private donors.

In principle, one could apply this utilitarian logic to transfers of all sorts. Whether one might want to do so depends on whether one accepts the utilitarian principle as the overriding one that should guide tax policy. To evaluate how compelling this utilitarian argument is, it is useful to consider the various caveats that might apply. We list them in no particular order of importance.

### The Standing to the Donor of Transfers

The utilitarian approach leads to a form of double-counting in the sense that the transfer is taken to give utility both to the donor and to the donee, and thus calls for taxation in the hands of both. Whether or not this is appropriate is a matter of judgment. One could equally well depart from strict utilitarianism and argue that a transfer of funds from one taxpayer to another should be treated like a transfer of the tax base and should only be taxed once. Recall that the *Meade Report* discounted this argument out of hand. But, it also seemingly argued against the simple principle of treating a transfer as taxable to both the donor and the donee, and suggested some separate treatment.

To make this point more forcefully, the double-counting can occur because both the donor and the donee obtain utility from the consumption of the latter financed by the transfer, because of, say, altruism. The same double-counting will occur under strict utilitarianism even if altruism is not accompanied by a transfer: person A may get utility

from person B's consumption even if there is no transfer from person A to person B. More generally, the strict utilitarian approach would require that any form of interdependent utilities count from a social welfare point of view. In other words, some judgment must be made about whether it is appropriate to include the benefit to both the donor and the donee from the same transfer in their respective tax liabilities, even though such common benefits are not included as taxable in the absence of a transfer. At the very least, this inconsistency would have to be reconciled.

Altruism might not be the only motive for a voluntary transfer. Some argue that a donor might be motivated by a 'joy of giving' (or a 'warm glow', following Andreoni, 1990) without regard to the benefit that the donee might enjoy. Or, donors may obtain prestige value from the size of the donations they make, at least to the extent that they are publicly observable. Alternatively, there might simply be ethical motives involved. This may or may not influence the way one thinks donors ought to be taxed. In any case, since motives are not observable, it would be impossible to differentiate tax treatment by motive in the case of voluntary transfers.

More generally, non-utilitarian arguments might be brought to bear in favour of not giving tax relief to donors for transfers they make. As mentioned above, if donations are taken to be the free exercise of one's chosen preferences, the principle of responsibility would say simply that the tax system should treat no differently those who chose to make donations and those who chose not to. By this argument, the only tax consequence of donations would be that they increase the opportunities available to donees and should be taxed as such. Unlike utilitarian arguments, this argument does not require recognising donations as acts of consumption.

### Involuntary and Requited Transfers

Transfers on death may differ from lifetime transfers in two ways. First, they may seem to be involuntary, as in the case of unintended bequests. If donors have held wealth for precautionary purposes to self-insure against uncertainty in the length of life, transfers of wealth at death might be considered involuntary in the sense that the wealth was not retained for the purpose of making a transfer. On the other hand, the holding of precautionary wealth is not itself without benefit to the donor since it presumably yields some value in terms of risk reduction. A clearer case might be that in which the wealth held at death is simply a result of bad planning, myopia or bounded rationality as has been stressed in the behavioural economics literature. Here it seems clear that there is no benefit for the donor associated with the wealth transferred, so the case for taxing a transfer on death simply on utilitarian grounds is weak. On the other hand, since the transfer is not made until the donor dies, there is presumably no way of offering a tax credit for it, and on efficiency grounds a tax on unintended transfers is unlikely to cause any unwelcome distortion.

Second, transfers on death may represent exchanges for services obtained from the donee while the donor is alive. For example, donor tells donee that he will receive wealth in return for personal care or attention while alive. Lifetime transfers are unlikely to be done on this basis. In this case, it is no different from any other voluntary exchange where the seller of the service (the donee) is rewarded for the service performed and the donor makes a purchase just like any other consumer purchase. Of course in this case (as

many court cases illustrate) the donee may provide the services but still not receive the reward on the donor's death if he chooses to leave his assets elsewhere. In this case, there is no double counting from including the value of the transfer as part of the tax base of both the donor and the donee.

Despite the fact that one may want to treat transfers differently for tax purposes depending on the donor's motive, in practice motives could not be observed with sufficient certainty to warrant taking them into account in defining the tax base.

## Transfers to Heirs

Transfers of wealth to heirs, either at death or *inter vivos*, constitute a substantial share of wealth transfers. Although there may be no compelling reason for treating intra-family transfers differently from those made outside the family, some conceptual problems with the utilitarian approach can be seen at their starkest in this case. Parenting obviously entails providing goods, services and funds to one's offspring. Does one adopt the utilitarian point of view here and treat the act of giving to one's children as yielding utility benefits to both the parents and the children? Such a position would have significant implications for the tax treatment of the family, implying, for example, a higher tax burden on a single-earner multi-person family than on a single person with the same income. One might argue that children are not taxpayers, so their utility ought not constitute a base for taxation. But, by that argument, one would also have to rethink the consequences of transfers to one's children (while they were still children) at death. Of course, one could argue that transfers at death to one's children provide wealth that can be used over the life of the child when their utility does count. But, *inter vivos* transfers, even in kind, could yield future benefits for the child: the most obvious perhaps being private tuition.

A form of *inter vivos* transfers that is now recognised as being of great importance to children consists of human capital transfers, that is the transfers of knowledge, skills and other traits that contributes to the child's future well-being. In principle, the utilitarian logic should apply here as well. If transfers of financial wealth should be taxed because they yield utility to both the donor and the donee, the same should apply to transfers of human capital. Given that it is difficult to do the latter, the question is whether full taxation should apply to the former.<sup>8</sup> Perhaps this is one source of the principle of separate treatment of wealth transfers that the *Meade Report* had in mind.

The case of intra-family transfers also makes the consequences of double-counting transparent. Suppose that as one goes down the line of a family, each generation passes on to the next generation on average what they received from the previous generation. (Deviations from the average would occur, for example, if some generation had unusually bad or good luck.) The utilitarian logic would imply that the wealth transfer is repeatedly taxed each generation under either an income or an expenditure tax system despite the fact that it had not been dissipated for consumption or allowed to grow. Whether this is a

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<sup>8</sup> The consequences of intra-family human capital transfers not being taxed are mitigated to some extent by the active role the state plays in the provision of public education.

reasonable outcome is a matter of judgment, but it is a consequence of the utilitarian logic.<sup>9</sup>

More generally, intra-family transfers lead to more profound consequences if one takes the utilitarian viewpoint seriously. A transfer from a parent to an offspring could conceivably give utility benefits to several persons: the donor, the donee, the donor's spouse, the donee's siblings, and so on. There is certainly no practical way of taking these benefits into account in the tax system even if one wanted to do so. The point is simply that relying solely on the utilitarian principle has its limitations. It ultimately leads to seemingly absurd prescriptions, so some compromises are necessary.

## Externalities

Some forms of wealth transfers can be thought of as generating positive externalities in the sense that they benefit third parties. Donations to charities and non-profit organisations are potential cases in point. Rather than subjecting these transfers to additional taxation, some tax relief is usually given. For example at present there is no inheritance tax or capital gains tax on transfers of assets to UK charities and in certain cases income tax relief is given. The tax incentives are even more favourable in the US. Consider the basis for this from the utilitarian perspective. Suppose first that a well-to-do donor transfers wealth to a poor donee who is not a taxpayer, and that no one else's welfare is affected. A utilitarian tax system would tax the donor on the transfer as if it were an act of consumption. Since the donee is not a taxpayer, receipt of the transfer would have no tax consequences although of course receipt of any significant sums would soon result in a donee being subject to income tax.

The argument for deviation from this treatment arises if other persons benefit from the transfer made to the poor, say because of their altruism. One might on these grounds argue that because external benefits are being generated by the donation, those benefits should be rewarded by sheltering the transfer from full taxation such as through a credit or a deduction. That logic would be fine as far as it goes. However, the third parties who are obtaining the altruistic benefit from the transfers are themselves better off, so their tax liabilities should rise accordingly. Since that is practically impossible to do, the case for subsidising the initial transfer might be tempered. This again illustrates that the utilitarian logic can lead to some perhaps unwanted or unexpected conclusions.

A more compelling case for subsidising transfers to charities and non-profits might be that the alternative for the government is to finance them directly. Given that it is costly

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<sup>9</sup> In the economics literature, it has been argued that if bequests are motivated by parental altruism so that each parent's utility includes the utility of their immediate heirs, a dynastic utility function can be constructed by recursive substitution of heirs' utility functions into parents starting with the current parents. Allocation of the future income stream of the dynasty among consumption for each cohort can be viewed as the result of the maximization of the dynastic utility function, and intergenerational transfers are a sequence of optimal bequests. This leads to so-called Ricardian equivalence whereby attempts by the government to engineer intergenerational transfers will be frustrated by offsetting changes in bequests (Barro, 1974). One might be tempted to think that according to this view of the world, bequests should not be taxed. However, that would be incorrect. The dynastic utility function represents only the utility of the current old generation, and does not include the utilities of each future generation in their own right (i.e., except as the indirectly provide satisfaction to the oldest generation). Thus, in the unlikely event that Ricardian equivalence is valid, it has no implications for the issue of wealth transfer taxation.

for the government to raise revenue because of the distortions it imposes on the economy, it might be more efficient for the government to subsidise charitable contributions by willing donors than to make the same overall donations directly.<sup>10</sup> These arguments do not apply to ordinary wealth transfers since the government typically has no policy interest in facilitating those transfers.

## Consequences of the Tax Mix

So far, we have considered if and how the tax treatment of wealth transfers on utilitarian grounds should be integrated with direct taxes, either income or expenditure. In fact, a substantial proportion of government revenue comes from other taxes, especially indirect taxes like the value-added tax (VAT). The VAT is like a proportional expenditure tax and ought to be treated as such from the perspective of how the overall tax system impinges on different taxpayers in the economy. To the extent that one views the transfer of wealth as analogous to acts of consumption to donors, as a utilitarian tax designer would do, this ought to be treated like any other form of consumption under the VAT. Thus, donors should be subject to VAT on their transfers over and above the direct tax liabilities they incur. This consideration might lend support to the argument of the *Meade Report* that wealth transfers be treated separately from the direct tax system, though in this case it might lead to harsher tax treatment.

## Design Issues

Suppose one accepts the argument that wealth transfers constitute a legitimate base for taxation in the hands of both the donors and the donees. There are a number of design issues that must be confronted in implementing such a tax, either as part of the direct tax system or as a separate tax à la the *Meade Report*.

First, there is the question of lumpiness. The size of the transfer could be large relative to the donee's annual income. Under an income tax system, one would want to average the transfer over more than one year, especially if the donee is very young and not yet a taxpayer. A flat tax rate on transfer receipts, as in the *Meade Report* LAWAT, would avoid this problem. Under an expenditure tax system, this is less of a problem since the taxpayer can self-average by smoothing their consumption purchases and varying their mix of registered and tax-prepaid assets holdings.

However as outlined below one could have a separate schedule of rates for a donee on receipts of wealth transfers to deal with lumpiness issues. (After all there were separate schedules of rates for donors under the capital transfer tax regime.) So by way of example only the first £100,000 of capital received by any individual from any source might be taxed at 0% then at 20% up to the next tranche of say £300,000 then at 30% etc with each receipt being added to the cumulative total.

Second, the scope of transfers to be included in a wealth transfer tax would need to be decided, in particular, how comprehensive it should be. There are various types of transfers that might be considered for partial or full exclusion. We have already discussed transfers to charitable organisations and non-profits. Some might argue that special

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<sup>10</sup> However, the evidence cited in Banks and Tanner (1998) for studies in the UK, the USA and Canada indicate that, at least in the short run, the price elasticity of charitable donations is typically less than one implying that the tax cost of increasing donations exceeds the size of the donations induced.

preferences should be given to transfers of a family house or a family business on social or other grounds. For example, incomplete capital markets might make it difficult for homeowners to release their housing equity at a fair price. Similarly, access to capital markets, leading to liquidity concerns, may be limited for those who own family businesses. In the end, no doubt political economy arguments might be an important deterrent to taxing the transfer of family houses (at least to spouses where it continues to be needed as a residence) and transfers of businesses. The limit to comprehensiveness might also arise from measurement difficulties, as in the case of transfers of human capital. Or, it may arise from limitations in administering a wealth transfer tax system using the self-assessment approach.

Special considerations (as occurs at present) would need to be given to transfers made to one's spouse or civil partner given their obvious interdependency. So for example a house which continued to be occupied by the surviving spouse should not be taxed on transfers between spouses whether this took place during lifetime or on death.

Next, the rate structure would have to be chosen unless the wealth transfers are fully integrated into direct tax systems. If wealth transfers are taxed separately, the choice of the rates structure would have to include exemption levels and rates. How should these compare with personal tax rates or with personal and VAT rates combined? The answer depends on whether the choice of a separate tax on wealth transfers is a matter of expediency or is guided by some yet to be articulated principles.

The design of wealth transfer taxation must also take account of various types of incentives. Since the tax would be triggered every time wealth changes hands, there would be an incentive to minimise the frequency of such transfers. In the case of bequests, one way to do this would be to skip generations or to use the device of trusts. These problems are relatively easily solved by taxing trusts as a separate entity with a separate life span (as now occurs in the UK) (although as outlined previously there would then have to be some scope for limiting the number of trusts set up by each donor) and either imposing higher tax rates on younger donees or higher transfer rates on transfers that skip a generation (as occurs in some countries). There would also be an incentive to postpone making a transfer in order to postpone or even avoid tax liabilities (if for example one political party opposed the system and intended to abolish it). The PAWAT and LAWAT proposed by the *Meade Report*, which had higher tax rates for younger donees than for older donees, were intended in part to mitigate these incentives, albeit by adding considerable complexity to the system. One simple way round the problem would be to impose a lower tax rate on the donee if transfers are made in the lifetime of the donor so that overall tax rates are then determined by the status of both donee and donor.

Incentives to save for the purpose of making future transfers would also be reduced, although this is simply the kind of incentive that goes with any tax system. To the extent that tax liabilities are affected by donee tax rates, there might be incentives in favour of splitting transfers into smaller parts and allocating larger amounts to donees with lower incomes or who have received smaller inheritances in the past. Both of these things might be regarded as socially attractive on grounds of distributive equity.

Political consensus will presumably also be important both in constraining the kinds of reforms that can be implemented, and in the response of households to reforms. For

example, if the Opposition disagrees with some tax reform that a Government announces, household decisions anticipate that policy reversals might occur if the Government changes. Thus, if a Government introduces a gift tax and that is opposed by the Opposition, taxpayers may simply delay making gifts.

Finally, in the case where wealth transfers occur on death, some countries apply the wealth transfer tax to the donor and others to the donees. Utilitarian logic can shed some light on this choice. As mentioned, when the direct tax applies to income, no relief should be given to donors, but inheritances should be taxed in the hands of the donees.

Presumably this is true whether the tax on wealth transfers is integrated into the income tax or taxed separately. No special problems arise if the system is a dual income tax system, once it is determined that wealth transfers should be aggregated with earnings and other transfers. If the personal tax base is expenditures, transfers on death ought to be treated as consumption for donors. If they are made out of registered assets, bequeathing ought to involve deemed deregistration. If they are made out of tax-prepaid assets, no further measures need be taken. For the donee, inheritances are simply treated as income received and treated as such for tax purposes. Conceptual problems arise if the tax is not integrated with existing direct expenditure taxes. The tax on wealth transfers would have to mimic a separate tax on expenditures by both the donor and the donees. For the donors, that can be accomplished by taxing the bequest under the wealth transfer tax, but exempting it from personal expenditure taxation. For the donees, the inheritance should in principle only be taxed to the extent that it is consumed. That entails allowing for the possibility of its being registered separately from other assets. The implication is that deploying a separate wealth transfer tax that respects the principles of expenditure taxation is difficult when it applies alongside direct expenditure taxation.

## 5. The Tax Treatment of Wealth

There are different ways of viewing the potential role of periodic taxes on wealth as opposed to the taxation of wealth transfers. One is as an alternative to taxes on income. As we noted earlier, an annual tax on wealth is analogous to a tax on the capital income from that wealth. To the extent that one wants to include capital income in the tax base, wealth taxation may be convenient for some types of assets, particularly those for which measures of asset income are not readily observable. For example, one might view taxes on owner-occupied housing as a way of taxing its imputed return, given that there is no rent paid on owner-occupied housing. In this case, arguably the tax should be on net housing wealth (after mortgage debt) rather than on the full value of the house although as noted earlier this makes the tax relatively easy to avoid. In an open economy setting where capital income earned abroad is not easily verifiable, a tax on wealth might be a rough and ready way of taxing presumed earnings. Of course, observability problems may be virtually as severe in measuring wealth held abroad as in measuring its capital income. Related to this, wealth taxation may be a supplement to capital income taxation where the latter is constrained by policy design. Thus, in a dual income tax system where capital income is taxed at a uniform rate, wealth taxation may be used as an additional policy instrument to achieve redistributive objectives. These arguments for wealth taxation as a means of enhancing the direct tax system raise no additional conceptual issues that are not already dealt with in the design of a direct tax system.

The more relevant question for us is whether there are cogent arguments for taxing wealth *per se* over and above those that inform the choice of a direct tax system. To put it another way, should wealth be subject to double taxation, once when it is created or transferred and again in its own right? If one takes a strict utilitarian point of view and argues that the proper base for taxation ought to be the consumption of goods and services that generate utility for the household, one might be led to argue against an additional tax on wealth. However, one can marshal other arguments, some utilitarian in nature, to support wealth taxation. Some of them are as follows.

### Wealth as a Source of Utility

As we have already mentioned and as the *Meade Report* held, it might be suggested that taxpayers do in fact obtain utility from wealth over and above that obtained by its use. Wealth might confer status and power on its owner, at least if held in sufficient and observable amounts. In addition, wealth might have some purely precautionary value as a device for self-insurance against unexpected future needs. And, it also buys security. To the extent that these things yield utility to the wealth-owner, it might be argued on utilitarian grounds that additional taxation should be attracted.

It is a matter of value judgment whether one accepts this argument that wealth adds directly to utility. To the extent that persons accumulate wealth over and above what they need for their own consumption purposes, their behaviour reveals that they obtain some benefit from it, although some of that benefit might also involve the benefit of donating it to their offspring. The fact that they choose to hold it for most of their lives rather than donating it earlier to their heirs might be taken to indicate that they obtain some value from holding it *per se*. For some such as the self-employed who may be less able to build up a valuable pension fund retention of wealth is seen as a substitute for pension planning – the idea that they are retaining some capital to assist them in future retirement.

Even if one accepts this argument that wealth bestows some benefit on its owner over and above its use for financing consumption, the issue arises whether that benefit should have standing for social welfare purposes. As in the case of altruism or other forms of interdependent utilities, these non-pecuniary sources of utility may or may not be viewed as appropriate metrics for determining tax liability. The fact that the benefits of wealth-holding are not measurable would make it difficult for the tax system to take them fully into account in any case. Given these caveats, and given that the usually specified benefits from wealth likely accrue mainly to persons who hold significant amounts of wealth, a separate wealth tax based on these arguments would probably be justified, if at all, mainly at the upper end of the wealth distribution.

### Non-Utilitarian Arguments

Another of the arguments given by the *Meade Report* for a tax on wealth was equality of opportunity. The objective of equality of opportunity seems to be a widely held one, but there seems to be no consensus about its explicit meaning. The broad interpretation put on it by Roemer (1998) is that persons ought to be compensated for disadvantages that they are endowed with, but should be otherwise free to exercise their choices according to their own preferences. Alternatively, Sen (1985) has stressed that persons ought to have comparable opportunities to participate in society, both in the market economy and in social interaction, and that these opportunities involve the accessibility not only to

purchasing power but also to credit, skills, and so on. Wealth can be seen as an instrument for enhancing one's opportunity in society, and giving one a stake in it or feeling a part of it. Some have even argued that all persons ought to be given a start-up grant or an ongoing basic income on these grounds, and more generally on the grounds of enhancing the freedom of persons to participate in society, and reducing the stigma of being dependent (Atkinson, 1972; Van Parijs, 1995, Ackerman and Alstott, 1999; Le Grand, 2006). Others have argued that an 'asset-effect' exists and that this justifies such a policy (Sherraden, 1991). While there is a lack of supporting empirical evidence, this argument was used in support of the Child Trust Fund – a lump sum payment to all newborns, with the funds locked away until age 18 – which has recently been introduced in the UK.

Unlike the previous argument, this argument for wealth being a determinant of tax design applies with special force for those at the bottom of the wealth distribution. A wealth tax itself would do little to reach those with limited wealth to begin with. This leads one to think of a progressive tax-transfer system for wealth, whereby those at the upper end pay a tax while those with limited or no wealth receive a wealth subsidy. We return to this below when we discuss the design of wealth taxation.

### Externalities from Holding Wealth

The suggestion of a progressive wealth tax might be given further support by the argument that wealth-holding leads to pure status effects whereby one's relative holding of wealth is what counts in generating pleasure rather than absolute wealth. According to this argument not only does an increase in one person's wealth have an adverse effect on other persons' well-being (which may or may not count from society's perspective), but more important, persons have an incentive to over-accumulate wealth in a sort of self-defeating rat-race. A progressive wealth tax would blunt this incentive. More generally, there seems to be some evidence that people have not become any happier as average incomes have increased rapidly in recent years (Layard, 2005).

At the same time, the behavioural economics literature suggests an opposing consideration. On the basis of psychological and experimental evidence, it has been argued that some persons are inherently short-sighted and tend to undersave against their own long-run self-interest (Bernheim and Rangel, 2007). To the extent that this is the case, taxing the accumulation of wealth would be counterproductive. On the other hand, there are other policy instruments in place to deal with undersaving, such as compulsory pension saving – or as recently proposed in the UK, changing the default so that employees have to choose not to be a member of a private pension arrangement rather than having to choose to join. In addition, any 'undersavers' might be expected to respond less strongly to financial incentives, and therefore the presence of a wealth tax might not diminish the amount that they chose to save.

### Design Issues

Assuming one accepts one or more of these arguments for a periodic tax on wealth, what problems would there be in implementing a wealth tax? A major problem is that wealth is accumulated for more than one reason. Some wealth exists for purely lifecycle smoothing reasons to reconcile differences in the pattern of consumption spending and income. For example, imagine a society in which all individuals had the same profiles of income and

consumption needs, but one or both of these varied by age. While there would be differences in wealth arising purely from lifecycle, saving it might not seem appropriate to tax this wealth for any reason of distributional concerns. Similarly, in a society where all individuals had the same expenditure in all periods, it is far from clear that individuals who received their income early in their life, and therefore who would choose to accumulate assets in order to finance their later life consumption needs, should be taxed more heavily than those individuals whose income profile happened to more closely match their expenditure profile. Presumably one would not want to subject lifecycle wealth to wealth taxation if the purpose of the latter is to tax persons on the basis of the pure benefits they obtain from holding wealth. In practical terms, the fact that the value of defined benefit pensions depends on final pensionable earnings and expected pension tenure means that it is difficult to accurately estimate current wealth since an individual who expected to have a longer pension tenure and a more steeply rising earnings-profile would have more expected pension wealth than an individual who expected to have a shorter pension tenure/less steeply rising earnings-profile.

Similarly, if wealth is accumulated largely to make bequests to one's heirs, other wealth-holding benefits might simply be incidental. A utilitarian tax designer might therefore want to tax wealth annually that was accumulated for reasons other than life-cycle smoothing, and might also want to tax the transfer of wealth to one's heirs (or to other donees).

Designing a tax system on wealth and wealth transfers that accomplishes this is challenging. To do so perfectly would involve distinguishing between wealth accumulated during one's lifetime according to whether it was intended for life-cycle smoothing or not. One might also want to be able to distinguish lifetime wealth accumulation that was done primarily for purposes of making a bequest versus wealth-holding *per se*, which is again impossible. The compromise proposed by the *Meade Report* was to tax, on a periodic basis, only wealth holdings that were obtained by bequest and not those that were the result of one's own accumulation. This would satisfy the wealth tax motive in part but is rather arbitrary in effect and of course would mean the tax is easily avoided by simply making lifetime gifts just before death.

It might be argued that an annual wealth tax is better targeted at specific assets such as land, with no reduction for debt and set at a relatively high threshold. So for example it would only affect real property owned by individuals, trusts or family companies with a gross value above a certain limit such as £1 million. There would be no exemptions (apart possibly for trading companies) and hence the status of the transferor – whether resident or domiciled here would be irrelevant. This tax then becomes relatively easy to collect since all local councils have a record of properties. Moreover the need for annual valuations could be avoided by imposing a 5 year revaluation similar to that used for pre-owned assets income tax. This would ensure foreigners holding property in this country (who can largely avoid the current raft of taxes including transfer taxes) would make some contribution and such a tax is not easily avoided if the objective is to hold land in the UK. The rate could be set at a relatively low level e.g. 1% rising to 3% on land values above say £3m. The tax could be paid as part of self-assessment on the basis that such persons are likely to have professional advisers anyway and therefore the compliance aspects are not significant. If the registered owner of the property is non-UK

resident then different mechanisms could be imposed but since the land is situated in the UK collection should be relatively straightforward.

In addition to the wealth tax on such assets there might be a separate tax on wealth transfers with no relief granted to the donor if one follows the utilitarian logic. As outlined in the previous section, this would involve such transfers as being equivalent to consumption on the part of the donor and a receipt of income by donees.

The idea of taxing transfers on the donee based on a cumulative total taking into account all the inheritances received over a lifetime is attractive but may be problematic to enforce. Transfers to spouses and civil partners will almost certainly have to be exempt. The exemptions applicable to assets such as business assets and farm assets also need to be considered.

It may be sensible to set the initial threshold at a high level so that, for example, a donee can receive up to £200K without paying any transfer tax but receipts after that level begin to be taxed on a progressive basis rather than the current flat rate of 40%. This would cover the problematic political issue of taxing “middle England” where the main asset is the family home. For most families with two or more children, transfers of wealth would be free of tax although obviously wealthier families would end up paying more. The taxable status of the donee needs to be considered – will tax be payable irrespective of the residence of the donee if the asset is situated in the UK and is the tax avoided if non-UK situated assets are transferred to non-UK resident or domiciled donees? If tax is imposed on transfers of UK situated assets it is relatively easy for foreign domiciled or non-UK resident donees to avoid by ensuring the assets are resited through use of foreign companies etc but the annual wealth tax would seek to tax continued retention of valuable UK assets.

The *Meade Report* proposed collapsing the wealth tax and the wealth transfer tax into a single tax, the PAWAT, which would be progressive in form. The authors reject this suggestion since it is unlikely to catch the very mobile but extreme forms of wealth that are prevalent in the UK. The advantage of keeping two systems is that the wealth tax system could be used as a more general mechanism for redistributing wealth along the lines proposed by Le Grand (2006) but affecting only high values within a relatively small class of persons who otherwise may be largely exempt from tax. .

Similar sorts of incentive problems arise with wealth taxation as with wealth transfer taxation. In the case of wealth taxation, the incentive would be to transfer the wealth early to avoid paying periodic tax. This might not be regarded as a serious problem. Once the wealth is transferred, it no longer yields the alleged benefits attributed to it. Moreover, the donee would – as long as they were resident in the same country – then be subject to wealth taxation, so the tax would not really be avoided. Of course, if the wealth tax is progressive, the donor could mitigate the future liability by dividing it up among donees. That might be a good thing since it would reduce the concentration of wealth.

The choice of tax structure for the wealth tax would be important. One could argue for a fairly progressive rate structure with a negative component at the bottom based on the arguments above that the main direct benefits of holding wealth would accrue to the upper level of the wealth distribution, while the case for a basic wealth capital grant applies at the bottom. An anomaly that might affect this is that, while the argument for a

wealth tax implies an periodic (e.g., annual) wealth tax, the argument for a basic capital grant may apply only once in the lifetime. In that case, the capital grant would not be part of the general rate structure of the annual wealth tax, but it could be financed from the proceeds nonetheless. It is also the case that while related separate decisions can be made over the taxation of wealth and any grant that is paid, it is highly unlikely to be the case that the appropriate amount of revenue raised through the wealth tax will be equal to the appropriate amount of expenditure on capital grants.

## 6. Other Taxes on Wealth and Wealth Transfers

The above discussion focused on direct taxes levied on persons based either on their general wealth holdings or on transfers of wealth to or from other parties. In practice, there are various other taxes on wealth or wealth transfers either levied indirectly or on specific forms of wealth. Whereas general wealth and wealth transfer taxes may be justified as being part of an equitable tax system based on some notion of a taxpayer's wellbeing or ability to pay taxes, the motive for other tax forms is typically tax-specific. Three categories of such taxes are briefly discussed here.

### Property Tax

An annual tax on some measure of the value of real property is used by local governments in many countries. The tax could be levied on renters as well as owner-occupiers as in the UK, or it could be on all property-owners as in other countries (US, Canada). When rates are proportional, it should not much matter. The tax is regarded as suitable source of own-tax revenues at the local level because the base is relatively immobile and tax liabilities might be related to benefits received from local public spending. Ideally, the tax facilitates local accountability for own-source revenues without compromising efficiency or equity in the national economy. There are a number of issues with respect to its role and design that we can briefly mention here.

While the benefit tax argument is one rationale for the local use of the property tax, in fact there is no evident one-to-one relationship between property tax liabilities and benefits from public services. On the contrary, empirical studies have shown that property taxes, and the quality of local schools, are at least partially capitalised into property values, which would not be the case if property taxes were offset by benefits from local services. That being the case, the tax can be viewed as one of many tax instruments for raising general revenues, albeit at the local level. The literature on the property tax has focused largely on its incidence, arguing that it combines features of a capital tax borne by owners of property more generally with features of an excise tax arising from differences in rates across localities (Wilson, 2003).

From the point of view of tax design, the property tax as it applies to individuals can be considered as a tax on the consumption of housing, or equivalently on its imputed return. As such, it undoes, somewhat imperfectly, the sheltering of imputed rents from owner-occupied housing in the personal tax base and perhaps also from wealth transfer taxation. Whether this is a good thing or a bad thing depends on one's views of the appropriate personal tax base. However, one aspect of incidence analysis takes on a special importance in the case of real property, especially that part of it consisting of land as opposed to buildings. If the market for property is reasonably forward-looking, future

property taxes are capitalised into property prices. This implies that initial owners of property effectively bear the burden of all expected future taxes (Feldstein, 1977). To the extent that this is true, it detracts from the value of property taxation as a component of a broader tax system. (Similar arguments might be made about wealth taxes more generally, at least to the extent that they apply to long-lived assets and their prices are not pre-determined as in the case of internationally traded assets).

Property taxation typically also applies to business property, both commercial or industrial. To the extent that the tax does not reflect benefits obtained from the use of the funds, this amounts to a form of wealth tax levied on businesses at source that is not closely related to profitability. As such, it affects business investment decisions and competitiveness with foreign producers in a presumably inefficient way, except to the extent that the tax is simply absorbed into lower land rents. The inefficiency of business property taxes is also mitigated by the existence of residential property taxes. Given these, business property taxes might be justified on second-best grounds as a way of removing an incentive to convert residential land into business land. To the extent that concerns over the inefficiency of business property taxes are valid, they have implications for the use of the property tax, and more generally for the manner in which local government is financed. A way of avoiding excessive property taxes is to adjust the size of grants to local governments from higher levels of government, taking care to do so in a way that preserves local accountability and avoids soft budget constraints.

Given that some amount of financing of local government will come from property taxes, the issue of tax design is relevant. Techniques now exist for tax administrators to maintain reasonably consistent and up-to-date estimates of property values, and to use those as a basis for annual taxation. There is thus no particular reason why property taxes cannot be based on estimated current property values, as opposed to historic values. In some countries, property evaluation is done by a higher agency, and local governments are given discretion for choosing their own property tax rates. Local choice is important because average property values can vary substantially across jurisdictions for a variety of reasons (demand for housing, amenity values, weather, etc.). Different localities will choose very different tax rates, even if they are providing comparable levels of public services. Indeed, for that reason, revenue-raising autonomy at the local level will typically be accompanied by some form of equalisation to compensate for the fact that different localities have different abilities to raise revenues.

The rate structure is typically more complicated than simply choosing a tax rate. Different rates may apply to different types or uses of property. Land (site value) may be taxed at a different rate than buildings, to the extent that that is feasible. Different rates may apply to residential, commercial and industrial property, although the principles that should inform that choice are by no means clear. Newly developed property may face differential rates to cover part of the cost of infrastructure. And, there may be some relief afforded to low-income property owners, such as by a system of credits delivered through the direct tax system or through a separate benefit (which might be important in countries, such as the UK, where the direct tax system operates on an individual basis and the benefit and tax credit system operates on a family basis). This may be particularly important for low-income persons for whom a house is their main asset, such as retired persons.

## Stamp Duties

Taxes on specific forms of asset transactions are used in many OECD countries, although they do not constitute a major source of revenues. Many countries impose stamp duties on property transactions. The rate of duty may be related to the value of property. In the UK, stamp duties also apply to sales of shares in UK corporations regardless of where the transaction takes place and who does the transacting. The tax is proportional and based on the value of the transaction. The argument for stamp duties is not at all clear, apart from a revenue-raising motive. One might argue that the tax is a user charge to offset the costs to the state of maintaining ownership records in the case of real property or regulating the market for shares. However, that is far from convincing. Presumably asset transactions of all sort benefit from the general property rights and contracting laws enforced by governments. It is not clear why certain types of asset transactions should be singled out for a tax.

There are a number of drawbacks to stamp duties. Most important, they discourage asset transactions and therefore hinder the efficiency of asset markets. They may also discourage asset owners from investments that increase the value of their assets. In the case of share transactions, the stamp duty particularly hurts firms requiring finance for marginal projects by imposing a charge that is not related to profits. And, if, as in the UK, the duty applies only to shares of locally incorporated firms, it makes takeovers and mergers with non-UK firms more attractive (Hawkins and McCrae, 2002). For these reasons, there is a case for eliminating the stamp duty and making up the revenues from other sources, although it might be argued that this will create a windfall gain for existing asset owners to the extent that expected future taxes are capitalised into asset values. Perhaps this would be more politically palatable if it were done at the same time as reform of the wealth transfer tax to the extent that increases in the latter are seen as affecting roughly the same persons who would obtain stamp duty relief.

There is currently no stamp duty or SDLT currently imposed in the UK on transfers of wealth<sup>11</sup> since these are by definition gifts. The argument for an additional stamp duty charge on transfers of wealth is not at all clear, apart from a revenue-raising motive, assuming that existing transfers of wealth are taxed.

## Capital Taxes

Some countries apply taxes not on share transactions, but on some measure of the value of the capital of corporations. As with stamp duties, the case for capital taxes is not clear. They might be viewed as a form of alternative minimum tax on corporations. However, it is equally likely that they are motivated by revenue considerations. In this context, one advantage that policy-makers might see from taxing corporate capital is that since the capital is already in place, there is no immediate incentive effect from taxing it. This is the classic hold-up problem in a taxation context: even benevolent political decision-makers cannot refrain from taxing previously accumulated capital and cannot commit to such restraint.

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<sup>11</sup> With a few limited exceptions

Any wealth tax would presumably take into account land held by corporations which were controlled by families (otherwise the tax could too easily be avoided by holding all assets through a private company or other similar vehicle).

### Other Taxes at Death

At the time of death, other taxes besides inheritance or bequest taxes may be triggered. In most tax systems, capital gains are taxed on a realisation basis, that is, when they trade hands through sale. Realisation of capital gains may be deemed to have taken place at death since the assets will necessarily trade hands. In this case, the asset will be revalued from the point of view of the inheritor. At present the UK taxes lifetime gifts to capital gains tax (since these are generally free of inheritance tax) but transfers on death are only subject to inheritance tax and unrealised gains are wiped out.

Taxing capital gains on death or indeed on lifetime transfers of wealth might be regarded as anomalous if the asset is also subject to an inheritance tax, especially if it is levied on the estate rather on the heir's inheritance. But, from a utilitarian point of view, taxing fully the income of donors while also taxing inheritances received by heirs is consistent.

Arguments for special treatment might arise in some cases. Housing used as the primary residence of the taxpayer may be exempt from the capital gains tax (as is the case in the UK), although it may well be subject to inheritance tax. Realisation of capital gains on assets that are transferred to a spouse on death may be postponed until the spouse dies. And, assets that are donated to charities may be absolved of capital gains as a means of encouraging such donations. At the same time, to be consistent, assets transferred as a gift before death might also be subject to deemed realisation.

Another form of transfer that can occur at death is the payment of life insurance proceeds to a named beneficiary. In principle, this would be treated like any other asset transferred from a donor to a donee. Under utilitarian logic, it would be taxed in the hands of the recipient. The difficulty is that life insurance proceeds are often paid to recipients who are necessarily vulnerable – minors where the father has died and therefore the future earnings potential has been eliminated. In these circumstances taxing the proceeds of such policies seems inequitable – presumably life insurance proceeds could be exempted where they pass to minor children or the spouse of the deceased.

## 7. Policy Options

None of the main proposals for wealth and wealth transfer taxation in the *Meade Report* were acted upon which demonstrates the practical difficulties in this area. In what follows, we summarise some of the policy options and implications of the previous discussion for each of the main tax categories.

### Wealth Transfer Taxation

If one adopts a strict utilitarian approach to tax design, the inescapable implication seems to be that a voluntary transfer from a donor to a donee should enter the tax base appropriately for both.

For the donor, the transfer is a use of income comparable to spending on consumption, which for the donee it is a receipt of income. This point of view is also consistent with

the equality of opportunity perspective according to which how some persons choose to allocate their income among different uses should not be a matter of relevance for taxation. The fact that persons choose to donate varying amounts of their income to others should not be penalised or favoured by the tax system.

There are, however, some potentially troublesome consequences of this point of view. For one, some may object to the double taxation of transfers and argue that they are simply reallocations of purchasing power from a donor to a donee so ought to be deductible to the former. For another, consistent application of the utilitarian principle seems to lead to very uneasy conclusions as we have seen. For example, all forms of interdependent utility, including altruism as well as avarice, should lead to complicated tax consequences. Families would be particularly hard hit by this. To avoid this, one must arbitrarily draw the line where utilitarianism does and does not apply. (These consequences do not arise, however, if equality of opportunity is the guiding principle.) Deviations would presumably also apply for other reasons, including second-best considerations (the inability to tax some forms of transfers, such as human capital), incentive arguments, administrative considerations, and so on.

In what follows, we take the perspective that wealth transfers ought to be treated both as a taxable use of income by donors and as a taxable receipt of income for donees. This will at least serve as a benchmark from which other perspectives might be proposed. We outline some policy consequences of that perspective, many of which summarise what has already been said.

Transfers should be included on as comprehensive a basis as possible for both donors and donees. Transfers of all forms should be treated on a par, whether gifts during lifetime or on death, cash transfers or in-kind transfers. No attempt should be made to take account of the motives for transfers or the relationship of the donee to the donor except perhaps in the case of spouses or charities where different considerations might apply.

The treatment of transfers should also be consistent with other uses and receipts of income. There seems no reason why transfers need to be integrated with the direct tax system but they could be subject to a separate tax as advocated by the *Meade* Report which would avoid some of the problems of lumpiness since the cumulative total would operate over the lifetime of the donee. The status of the donee and in what circumstances transfers to non-residents or non-domiciliaries are taxed needs to be considered. Some anti-avoidance legislation would be needed to deal with transfers to trusts so that in effect only one trust per donor could be used.

As far as possible transfers of assets such as businesses land or art would not receive special attention – practically this could be achieved by making the threshold before any transfer tax was levied relatively high. There would be a case for integrating the capital gains tax and inheritance tax systems so that only one tax is levied on transfers of wealth.

If transfers of assets such as farms are to be tax-exempt, the reasons should be clearly articulated. The current reliefs are not conditional, so on death there is no tax payable on the transfer of the business (neither capital gains tax nor inheritance tax) and the business can be sold the next day without any clawback of the relief. So it is hard to see how the relief encourages retention and growth of family businesses in its current form. On the

other hand, making the tax relief conditional on retention of the business could distort decision making.

Transfers to charitable and non-profit organisations also deserve special attention and presumably would continue to be exempt as a matter of policy.

Finally, the design of wealth transfer taxation must take due account of incentives. From the point of view of the donor, three sorts of incentives issues are prominent. First, to the extent that different forms of wealth transfer are treated differently, there is an incentive to substitute with favoured forms. Thus, acquisition and transfers of businesses may be substituted for cash transfers. In practice this can be dealt with by making such reliefs conditional on retaining the asset – although again this may distort decision making.

Second, if transfers are taxed in the hands of donees, there is a disincentive to make transfers as opposed to the donor consuming them or pursuing other alternatives, such as generation-skipping. Third, to the extent that wealth transfers are financed by assets accumulated over the donor's life, there is a disincentive to save. If these adverse incentives are judged to need attention, they might affect the rate structure. Indeed, if the incentives arising from wealth transfers are deemed to be greater than for other forms of income, differential tax treatment might be called for. This may not be as great a problem as it seems, though. Given that earnings are also indirectly taxed through the VAT, even if wealth transfers were fully integrated with the system of direct taxes, they would still be preferentially treated because donors pay no VAT on wealth transfers. One could presumably apply VAT to wealth transfers, although the inability to tailor the tax rate to the donee leads to problematic equity concerns.

## Wealth Taxation

The case for taxing wealth in its own right is separate from the case for wealth transfer taxation. It relies on some notion that wealth itself is a suitable source of taxation because of the benefits, opportunities, power, prestige, etc, that it gives owners over and above its value in terms of the income and consumption it finances. While the *Meade Report* accepted this argument on face value with little or no justification, it is by no means clear that it represents enough of a societal consensus to warrant imposing a major new tax on wealth. At most, one might argue that a wealth tax could be imposed at the top end of the wealth distribution as a way of breaking up large sums of inherited wealth. However, even this argument is not fully convincing, since much the same objective could presumably be achieved by integrating wealth transfers fully into the direct tax system along the lines suggested above. There may be practical or political arguments that preclude wealth transfer taxation from doing that job, such as the perceived difficulties of containing the ability to use trusts to avoid wealth transfer taxation.

Nonetheless, there may be a constituency in favour of wealth taxation, and one may therefore want to consider some of the issues that need to be considered in designing such a tax. For one, the measure of wealth to be used in such a tax base should be comprehensive. It should include not only real and financial assets, but also imputed forms of wealth such as pensions. The latter could be impractically difficult to measure where they take the form of defined benefit pensions. As well, measuring the value of personal items like jewellery and works of art would be challenging, as would assets held outside the country. A further issue arises with wealth that is held for purely life-cycle

smoothing purposes. It is not clear that one would want to include it in a wealth tax base, but it would be practically impossible to exclude it accurately.

It was issues of this type that led the *Meade Report* to draw a distinction between wealth accumulated during one's lifetime and wealth inherited, and to propose that the wealth tax be imposed only on the latter. This seems to have been the main rationale for the choice of a single tax instrument (the PAWAT) as a device for achieving the objectives of both wealth taxation and wealth transfer taxation. There is a relatively heavy price to pay for this, however. Wealth transfer taxation becomes disentangled from the direct tax system, which seems to go against first principles. More important, the system becomes a highly complicated one because of the requirement that wealth transferred be taxed not once but each year for which it is held. It is complicated further by the need to structure the tax to avoid incentives to manipulate the timing of wealth transfers. Effectively, one has an age-specific tax system, which is complicated for both taxpayers and tax administrators alike.

The price to pay for integrating wealth and wealth transfer taxation into a single tax separate from the direct tax system seems to be excessively high. It would be much simpler to integrate wealth transfer tax system with the direct tax system, and deal with wealth taxation independently to the extent that is desired. Given the problems involved with treating wealth accumulated from working and saving during one's lifetime differently from wealth obtained as a windfall, and given the fact that the supposed benefits of holding wealth apply especially to large wealth-holders, a second-best approach might be to impose a separate wealth tax on the latter alone. This amounts to a personal wealth tax with a high threshold, and with a rate structure that could have some progressivity. Obviously, the usual administrative, political feasibility, and incentive effects would arise with such a tax.

Finally, to the extent that one does accept that wealth contributes directly to one's wellbeing, the argument may also apply at the very bottom of the wealth distribution. Small amounts of wealth, especially for younger persons, might be very valuable as a means of providing a source of credit that can create opportunities that might otherwise not be available. This is presumably the rationale for the Child Trust Fund in the UK. Of course, to the extent that these are simply intended to offset credit market imperfections, their form may as well be loans rather than outright grants. However, there is no particular reason to treat these as part of a progressive system of wealth taxation. They are once-off payments to the young rather than being an annual tax on wealth.

## Stamp Duties

As mentioned earlier, the case for stamp duties that are narrowly applied to real property transactions and to stock transactions has a weak economic rationale even from a revenue-raising perspective. It seems clear that if one were designing a tax system from scratch, stamp duties would not be a component. There may have been a time when they were attractive simply because they were easy to administer and difficult to evade compared with other revenue sources, but that advantage seems not longer to be so important.

Stamp duties are not just innocuous minor taxes: they do impose distortions on business decisions that seem unnecessary. Should these taxes now be abolished? There are two

potential costs of abolishment. One is the revenue cost to government, but that seems to be a misplaced concern given that the same revenue could be raised in a less distorting way. The second is the argument that eliminating stamp duties will create windfall gains for existing owners of real property and stocks, since future tax liabilities are to some extent capitalised into current asset values. Thus, future efficiency gains from abolishing or reforming the tax would be partly offset by transfers to current asset owners, though how much is an open question. To what extent should this kind of horizontal equity argument preclude tax reform? This is an ever-present challenge for tax reform.

## Council Taxes and Business Rates

Taxes on real property – council taxes and business rates – constitute a reasonable revenue source for local governments, particularly if the latter have some discretion over the rate within their jurisdiction and retain the revenue-raised for their own uses. A broader issue is the extent to which local jurisdictions should be responsible for raising their own revenues, and the balance between property tax revenues and other revenue sources such as user fees. This is an open question. In larger cities, it is feasible to use local income taxes, but this is not an option for smaller ones. There are also alternative easy way of taxing local property owners or users. For example, taxes based on some measure of property besides its market value could be used, such as frontage, and size of property or building. In the extreme, simple head taxes could be a source of revenues, although problems with them are now well-known. In fact, property taxes are well established as local taxes, so it is worth considering elements of their design. Some principles might be recommended.

First, it is feasible to base property taxes on estimated market values rather than bands, especially bands that have been determined years ago. There exist reasonable tax administration procedures developed in other countries for estimating market values for properties on a frequent and regular basis (e.g., every 2-3 years). Given an established system of market value assessment, local governments could then apply their own rates according to their needs and preferences. Residential property taxes could be applied to the occupiers of the properties – owners or renters – as in the UK, or the owners of the properties as in some other countries. That should not affect the ultimate incidence of the tax. Indeed, there may be political economy reasons for taxing occupants so as to avoid the incentive to tax and spend at the expense of absentee landlords. Taxes could be proportional or progress with the value of property. The latter might have significant disincentive effects, although that may be justified to the extent that it is seen as a substitute for imputed rent not appearing in the direct tax system. There could be relief for low-income taxpayers delivered as a refundable tax credit through the benefit system, as is currently the case. In fact, one argument for imposing the property tax on renters rather than owners is that it facilitates attribution of property tax relief to low-income occupants who pay for the use of the property.

The case for taxes on business properties is perhaps less compelling than for residential properties. To the extent that businesses benefit from local services, these can be recouped to some extent from user fees. Moreover, businesses are more mobile than households, and local taxes are likely to distort their location decisions. Tax competition effects can be muted by coordinated setting of business rates, but this would defeat the purpose of property taxes as a local revenue source. As mentioned earlier, the one

efficiency argument favouring business tax rates is that they remove a distortion that might otherwise exist between the use of property for business as opposed to residential purposes, given that the latter is subject to property taxation. More generally, business property taxes constitute profit-insensitive levies that lead to inefficient business decisions. Despite the possibility that they may level the playing field between residential and business properties, the case for business property taxes is not a compelling one. However, abolishing them would lead to the same sort of windfall gains as in the case of stamp duties, so one would have to trade off efficiency gains versus the potentially large windfall gains that would occur to existing business property owners.

Finally, an overriding issue that helps inform the use of property taxes concerns the extent to which local governments ought to be responsible for raising their own revenues. From an accountability perspective, the responsibility of local governments for raising their own revenues, especially at the margin should be valuable, particularly where they also have some discretion over local spending decisions. Such fiscal accountability can be important for encouraging efficient service delivery as well as avoiding soft budget constraints. At the same time, different local governments will have different abilities to raise revenues and different expenditure needs. This can give rise to inefficiencies in the allocation of resources across localities and differences in the level of public services that can be delivered to otherwise identical persons in different localities. The antidote to this is a system of equalisation transfers among local governments so that they can provide comparable levels of public services at comparable levels of taxation. Almost all federations have formal equalisation systems that are intended to achieve that objective. In the case of unitary states, equalisation systems among localities exist as well. They are highly developed in the case of Japan and the Scandinavian countries, for example. It is beyond the scope of this paper to consider these in more detail. But, any reform of the system of local property taxes would have to confront the differences in fiscal capacity among localities to which decentralised property taxes give rise.

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## Appendix A. The UK Tax Treatment of Wealth and Wealth Transfers

As in most OECD countries, the UK tax system includes a variety of taxes on the transfer of wealth and on wealth itself. What follows is a brief description of the main elements of wealth transfer and wealth taxation in the UK.

### Taxation of wealth transfers

#### *Inheritance tax*

Inheritance tax is levied at 40% on the value of estates over a threshold, which in 2006–07 was set at £285,000. Inheritance tax is based on the principle of “loss to estate”. Hence the tax is not generally levied on the value of what has been given away but rather on the loss to the transferor’s estate.<sup>12</sup> There are a range of exemptions and reliefs, the most important of which are the following:

1. Spouse exemption: transfers between spouses and (from 5 December 2005) civil partners are generally exempt from inheritance tax whether during lifetime or on death. Since assets that pass to a surviving spouse or civil partner are free of inheritance tax in practice no tax is normally due until the second spouse dies.<sup>13</sup> There has been some pressure recently to extend the spouse exemption more generally to cohabitants and other persons living together.<sup>14</sup>
2. Charitable and related exemptions. Assets passing to UK charities and political parties are also free of inheritance tax. Recently the limitation of charitable exemption to UK charities has been challenged by the European Commission.<sup>15</sup>

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<sup>12</sup> So for example the gift of a 2% shareholding by someone owning 51% of a company would result in a substantial loss to his estate albeit the value of what he has gifted is relatively small. Capital gains tax is not based on the loss to estate concept but the value of what has been gifted.

<sup>13</sup> There are certain exceptions where the transferee spouse is not domiciled or deemed domiciled in the UK in which case the spouse exemption is limited to £55,000.

<sup>14</sup> See for example *Holland case refer* and the recent case of *Burden v Burden* insert case refer where two elderly sisters living together argued that they should have an exemption equivalent to the spouse exemption on the basis it was discriminatory because they could not enter into a civil partnership being blood relations. The European Court rejected their argument – they held that a difference in treatment is discriminatory if it has no objectionable reasonable justification but argued that the sisters were not in a similar or analogous position to other cohabiting couples. The sisters were connected by birth rather than any decision to enter into a formal legal relationship. The majority of the court held that the promotion by the Government of marriage was a legitimate social aim. The limitation of the inheritance tax advantages to spouses and civil partners was a proportionate measure to achieve the Government’s social agenda. So the majority held that there had been no violation of the sisters’ human rights. Since the Government allows single sex and opposite sex partnerships the option of registering a marriage or civil partnership and thereby obtaining the benefits of the inheritance tax exemption it is not thought that a claim that cohabitants are discriminated against will be easily upheld.

<sup>15</sup> The European Commission has decided to challenge the current UK tax regime which allows tax relief for gifts to charities only if they are established in the UK. The European Commissioners issued a formal request to the UK Government in the form of a reasoned opinion on 10<sup>th</sup> July 2006 to end discrimination against foreign charities. Although it was stated that if the UK did not reply satisfactorily within two months to the reasoned opinion the Commission may refer the matter to the European Court of Justice there are currently no signs of a UK response nor a referral by the Commission.<sup>15</sup> The Commissioners argue that

3. The PET regime. Outright lifetime gifts (i.e. not into trust)<sup>16</sup> are exempt from inheritance tax as long as they are made more than 7 years before death, and the donor gives up all benefit from the asset in the 7 years prior to the date of death. Gifts made in the 7 years prior to death are taxed or (if they are under £285,000) will increase the remaining estate which is taxed at 40% on death. If tax is payable on the lifetime gift,<sup>17</sup> the tax payable is reduced by 20% each year after the first three years. Such lifetime gifts are called potentially exempt transfers (“PETS”) and were introduced in 1986. Prior to that date, inheritance tax (or capital transfer tax) operated initially as a cradle to the grave tax and then over a ten year cumulation period and hence lifetime gifts over a certain threshold reset every ten years were subject to tax (albeit at lower rates). The ability to make gifts free of tax if the donor survives 7 years has tended to favour those with more liquid assets or greater wealth who can afford to make gifts during their lifetime. The main criticism of the PET regime in recent years has been the inability of “middle income” persons whose main asset is the home they live in to give it away during their lifetime tax effectively. The increasing value of people’s homes has led to a proliferation of schemes to avoid inheritance tax by giving away the family home and retaining the use and benefit. This in turn led to the introduction of POAT – discussed later.
4. Agricultural property relief. Farmland qualifies for relief from inheritance tax typically at a rate of either 50% or 100%. The relief from inheritance tax is given on agricultural value not hope value which may be substantially greater. The relief has been extended since 1995 to include 100% relief on tenanted farms. Certain minimum periods of ownership are required (2 years if the land is being farmed in hand and 7 years if tenanted) to prevent death bed planning. Farmhouses can also qualify for relief although recent cases<sup>18</sup> have shown this to be a controversial area and subject to a number of limitations.
5. Business property relief. All unlisted trading companies or trading groups, listed companies where the deceased has control and unincorporated trading businesses

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the difference in treatment between gifts to charities in the UK and gifts to charities in other member states constitutes potentially:

- (a) an obstacle to the free movement of capital and therefore breaches Articles 56-60 of the EC Treaty,
- (b) is contrary to the free movement of workers since workers and self-employed persons moving to the UK might wish to make gifts to charities established in the member state where they came from (Articles 39-42 of the EC Treaty) and
- (c) is contrary to freedom of establishment (Articles 43-48 of the EC Treaty) i.e. the right of an EU national to exercise economic activity to establish an undertaking in another member state, since foreign charities are forced to set up branches in the UK in order to benefit from the favourable tax treatment.

<sup>16</sup> Since 22 March 2006 the only lifetime gift into trust which will be exempt from tax as a potentially exempt transfer is a gift into a disabled trust, narrowly defined. Before that date most lifetime gifts into trusts were exempt if the donor survived 7 years. While trusts generally gave few additional inheritance tax advantages over outright gifts, they did enable the donor to control the gifted property e.g. ensure it was used for specific purposes such as education. The Government has not abolished the exemption for lifetime gifts but severely reduced the attractiveness of lifetime giving by in effect requiring the donor to give up all controls over the asset in favour of donee.

<sup>17</sup> Only applicable if the gift itself exceeds the unused nil rate band in value.

<sup>18</sup> E.g. McKenna cite case refer

receive 100% relief from inheritance tax provided the transferor has owned the relevant asset for 2 years prior to the transfer. 50% relief is given where land is used in a qualifying business but owned by the transferor personally. Investment businesses such as let property are not exempt from inheritance tax (although let farms are exempt to the extent of agricultural value). However, the relief is complex and can depend to a large extent on how businesses are structured. For example in some circumstances it is possible to obtain business property relief on investment property if it is held within a trading group. The introduction of the 100% relief in [1992] was intended to encourage persons to hand on businesses to other family members but in fact has encouraged people to retain control and ownership since the relief means the asset is free of tax on death anyway. The inheritance tax rules governing business property relief on lifetime gifts are generally more relaxed than the capital gains tax rules governing whether business assets taper relief is available on lifetime gifts. Business property relief is not conditional so it would be possible for someone to inherit a business, sell it the next day and there would be no clawback of relief.

6. Lifetime gifts to companies that exceed the nil rate band threshold attract inheritance tax immediately at a rate of 20%, unless the donor owns the company shares.
7. There are limited reliefs on heritage property. Most of these are conditional.
8. Normal expenditure out of income exemption and annual exemption. It is possible for any individual to give away up to £3,000 per annum tax free without the need to survive any period. An individual can make regular gifts out of surplus income each year without paying inheritance tax (even if the gifts are into trust) and without the need to survive 7 years. The small gifts exemption allows an individual to make gifts of up to £250 a year free of tax to any number of individuals.
9. Trusts. There was a major overhaul of the inheritance tax treatment of trusts in Budget 2006. Prior to that date the Government had taken the view that property in trusts should not be taxed more adversely than property held by individuals but equally not benefit from any particular tax breaks. So the aim was to make the trusts tax regime broadly neutral compared with individual ownership. However, it was perceived that trusts were being used as vehicles for tax avoidance. Although the internal research study by HMRC did not in the end validate this perception it was presumably felt that donors would be less willing to make lifetime gifts if some fetter was placed on the controls that could be exercised over the asset thereafter. Donors have generally been less keen to transfer assets to their children outright than give the assets in trust with trustees controlling the investment and expenditure of such wealth.

Rather than restricting the PET regime more generally, the Government chose to place restrictions on gifts to trusts. Since 22 March 2006, any lifetime gifts to trusts will be subject to inheritance tax at 20% above the nil rate band threshold of £285,000 unless the property gifted qualifies for business property relief or agricultural property relief or the trust is a disabled trust (narrowly defined). The trust is then subject to charges of up to 6% every ten years thereafter (subject to business property relief and agricultural property relief) and similar charges on capital payments to beneficiaries. In practice the rate of tax is usually less than 6%. There is no tax

payable on trust property if a beneficiary dies or if the class of beneficiaries is altered unless the transferor has reserved a benefit in the trust. The tax payable by a trust is meant to represent the same total amount over the course of a generation as the tax that would be paid if the asset was owned by an individual who died. In practice due to reliefs such as spouse exemption and the PET regime applicable to individuals, property held by trusts is now likely to be taxed more adversely than property held by individuals. In addition gifts between individuals are PETs and not subject to any tax if the transferor survives 7 years while gifts into trusts are generally immediately chargeable at 20%.

The changes were made retrospective in relation to certain types of trust<sup>19</sup> In practice, since it is still possible for a married couple to give away between them £570,000 into trust tax free without any entry charge every 7 years (two nil rate bands), the changes affecting trusts will generally affect richer families.

There is a separate regime for property left in trust by Will. In this case it is possible to leave property in trust for a spouse<sup>20</sup> and still obtain the spouse exemption. Such a trust will not be subject to 10 year charges or exit charges but the property will be taxed on the death of the spouse. However, it is possible to give powers for the trustees to end the spousal life interest while s/he is alive, which will generally be a PET and therefore free of tax if she survives 7 years. The regime also allows other types of trust such as bereaved minor trusts (trusts for children of testators under 18) which are taxed more favourable.

Inheritance tax is forecast by the Treasury to raise £3.6 billion in 2006–07 (0.3% of national income). It is estimated that 37,000 estates, just 6% of all deaths, will be liable for inheritance tax in 2006–07. The nil rate band (currently £285,000) is indexed each year but has not kept in line with the growth in the underlying taxbase. Generally the yield of inheritance tax and the number of people paying it has been increasing in recent years.

### *Capital Gains Tax*

1. Capital gains tax is chargeable on a range of disposals including gifts although interspouse transfers are treated as taking place on a no gain no loss basis. Both capital gains tax and inheritance tax can be paid on the same transfer of wealth.<sup>21</sup>
2. The gains of each spouse are calculated separately and each is entitled to an annual exemption (£8,800 for 2006–07). Trustees generally enjoy half the annual exemption available to an individual but where the same settlor has created more than one settlement since 6 June 1978 the annual exemption is divided equally between them.
3. Capital gains tax is charged on any gain resulting when a chargeable person makes a chargeable disposal of a chargeable asset. Tax is charged on so much of the gain as is left after taking into account any exemptions or reliefs and after deducting any allowable losses. The tax is payable on 31 January following the tax year of disposal.

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<sup>19</sup> Principally accumulation and maintenance trusts for beneficiaries under 25 but also in some cases interest in possession trusts (where the beneficiary has an entitlement to income but not to capital). There is a transitional period until April 2008 which allows trusts time to reorganise.

<sup>20</sup> Giving her entitlement to income – an immediate post death interest trust – IPDI

<sup>21</sup> E.g. if the donor dies within 7 years or the gift is to a trust and 20% inheritance tax is payable.

For assets owned on 31 March 1982 the chargeable gain may be computed on the basis that the asset in question had been acquired in March 1982 at its then market value (so in effect all assets were rebased then to remove gains accruing between 1965 to 1982 from the tax charge). In calculating the gain there is an indexation allowance to allow for the effects of inflation for periods of ownership between 1982 and March 1998. The indexation allowance was abolished for periods of ownership from April 1998 in the case of individuals personal representatives and trustees but continues to apply in calculating the chargeable gains of companies and will still be relevant where assets sold after March 1998 were acquired before this date. Instead, individuals personal representatives and trustees now benefit from a new relief called taper relief which has been subject to considerable further change since 1998.

4. Taper relief: there are some complicated transitional provisions but broadly gains on disposals of business assets are taxed at the rate of 10% for a higher rate tax payer if the asset has been held for two years whilst disposals of non-business assets are taxed at a minimum rate of 24% for a higher rate taxpayer if the asset has been owned for 10 years. If the non-business asset has been owned for less than 3 years no taper relief is available. Thereafter, the rate of tax decreases by 2% each year. The rules governing what are business assets for capital gains tax purposes are narrower than the rules determining a business asset for inheritance tax purposes except that commercial lettings to certain trading businesses can qualify for BATR even if the owner is not involved in the business.
5. Capital gains tax is taxed on individuals at the rate of income tax applicable to the taxpayer which will be either the starting rate (10% for 2006–07) or the lower rate (20% for 2006–07) or the higher rate 40% for 2006–07. Capital gains tax is charged at the individual taxpayer's highest marginal income tax rate. (Prior to April 1988 capital gains tax was charged at a flat rate of 30% rather than linking the rates of income tax and capital gains tax.) Personal representatives and trustees are now generally subject to tax on all gains at 40%. In the case of "settlor interested trusts" (widely defined to include a trust which could benefit a minor child of the settlor, the settlor or his spouse or civil partner) tax is assessed on the settlor as if the gains had been realised by him and at his rates of tax not by the trustees. In these circumstances the settlor can recover the capital gains tax from the trustees.
6. There is a complex regime for set off of capital losses particularly where trusts are involved.
7. Disposal is not defined for capital gains tax but will generally mean any transaction where the ownership changes or the owner divests himself of rights in or interests over the assets. In certain circumstances the term is extended so for example trustees of a settlement are treated as disposing of and immediately reacquiring settlement assets at market value if a beneficiary becomes absolutely entitled or if there is a transfer of assets to a new settlement. Hence a transfer of assets out of a trust to a beneficiary may result in capital gains tax for the trustees. If, however inheritance tax is payable on a transfer of assets out of trusts to beneficiaries then the capital gains (which is generally charged at higher rates of 40% rather than the inheritance tax rates of 6%) can be held over. The beneficiary would then pay capital gains tax at his highest rate on a later disposal of the asset during his lifetime taking into account the held over gain. If he dies holding the asset then the gain held over out of the trust is

wiped out (but inheritance tax will then be payable subject to the availability of spouse or other exemptions.)

8. A gift or disposal of an asset at an undervalue is treated as a disposal taking place at open market value.<sup>22</sup> The donor is therefore deemed to receive the market value of the property that he has given away even though he has, in fact, received nothing. The donor is primarily liable for the tax due.
9. In addition to being treated as a disposal at market value for capital gains tax purposes, a gift of assets may be potentially chargeable to inheritance tax. In calculating the fall in value of the transferor's estate for inheritance tax purposes his capital gains tax liability is ignored. There is limited holdover relief for disposals of business or agricultural assets by way of gift or disposals into trust which are chargeable for inheritance tax purposes. In these circumstances if a hold over claim is made the donor is treated as disposing and the donee as acquiring the asset for its market value at the date of the gift less the chargeable gain which is held over.
10. There is no disposal of assets on death for capital gains tax purposes but they are deemed to be acquired by the personal representatives of the deceased at their market value. Hence, death generally wipes out capital gains. There are, however, exceptions to this. If, for example, a holdover claim has been made into certain types of trust the held over gain can, in certain circumstances, be clawed back on the death of the beneficiary.
11. The most important exemption from capital gains tax for the individual taxpayer is private residence relief which is available for any gain arising on the disposal by gift or sale by a taxpayer of his only or main residence, including grounds of up to half a hectare or such larger area as it is required for the reasonable enjoyment of the dwelling house. A similar exemption is available for the trustees holding a house occupied by a beneficiary.
12. There is clearly scope for double taxation on transfers of wealth and also scope for avoiding taxation altogether.

Example: A gives an investment property worth £1m away to his son in 2006–07. The gain after taper relief on the disposal is £200,000. Capital gains tax is payable at 40% of £80,000. A then dies within 3 years of the gift. Inheritance tax is payable of £286,000 which can be recovered from the donee or the donor's personal representatives. The inheritance tax cannot directly be reduced by the capital gains tax liability although obviously there will be less left in father's estate which is potentially subject to inheritance tax on his death. Father's remaining estate left on death will be taxed at 40% subject to spousal or business property/agricultural property relief.

Example: B transfers some quoted shares worth £500,000 into trust for his son. He has made no previous chargeable transfers. Inheritance tax is payable immediately on the transfer of £43,000. If his son is a child under 18 capital gains tax will also be payable on any gain arising on the gift of shares unless the son is excluded from benefiting until 18 along with all other minor children of B and B and his spouse/civil partner are excluded. The trust will pay inheritance tax at 6% based on the value of the property at the ten year anniversary. If distributions are made before that date then these will be subject to

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<sup>22</sup> s.17 18 TCGA 1992.

inheritance tax of less than 6% and any gain arising since settled into trust can be held over.

13. A person who is neither resident nor ordinarily resident in the UK is generally not liable to capital gains tax on gains even if resulting from a disposal of assets situated in the UK (with certain exceptions for assets used in a business here). This includes disposals of assets by non-UK resident trusts. Since 1998 there have been wide anti-avoidance measures which will tax the settlor of a trust on gains realised by a non-UK resident trust if a wide range of persons including settlor, spouse or civil partner, children or grandchildren can benefit from the trust.

### **Foreign domiciliaries**

These are subject to a special tax regime on transfers of wealth and on holding wealth. A person resident in the UK who is not domiciled here<sup>23</sup> will not pay inheritance tax on assets situated outside the UK unless UK resident for 17 out of the last 20 tax years. Even then inheritance tax may be avoided by transferring the assets into a settlement prior to him becoming deemed domiciled here. Trusts set up by foreign domiciliaries do not generally suffer any inheritance tax on assets situated abroad which are retained in trust, whether on a ten year anniversary or on the death of a beneficiary and even if the beneficiary is UK resident and domiciled. UK assets can be resited for tax purposes with relative ease.

Foreign domiciliaries will not pay capital gains tax on gains realised abroad (e.g. from disposals of assets by way of gift) provided the gain is not remitted by them to the UK. In practice foreign domiciliaries can make gifts abroad into trust or to relatives without tax being payable. Non-UK resident trusts which realise gains on UK or non-UK situated assets are not subject to capital gains tax and neither is the settlor or any beneficiary if foreign domiciled even if the gain is remitted to the UK and they are resident here.

Trust structures set up by foreign domiciliaries retain considerable tax advantages even for beneficiaries who are resident and domiciled in the UK.

### **Taxation of wealth**

#### *Council tax*

Since April 1993 council tax has been the only significant local tax across all of England, Scotland and Wales.<sup>24</sup> The occupants (i.e. not necessarily the owners) of domestic property pay an amount that depends on the banded value of the property and the rate that is determined by their local authority. There is a discount for one-adult households, and a means-tested benefit (council tax benefit) to assist those in low income families who have little other capital apart from their house. Those with second unoccupied homes are also liable for council tax, although councils in England can offer rebates of between 10% and

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<sup>23</sup> Insert definition.

<sup>24</sup> In Northern Ireland a different system of domestic property taxation was introduced from April 2007.

50% on these properties. Council tax is forecast by the Treasury to raise £22.5 billion in 2006–07 (1.7% of national income), net of the outgoings on council tax benefit.

In England and Scotland there are eight bands (A to H) with properties being allocated on the basis of their April 1991 values. This was also the case in Wales until April 2006 since when properties have been allocated to revalued bands (based on April 2003 values), with a ninth band (I) being introduced. As shown in Table 1 those in band D pay the standard council tax rate, while those in band A pay two-thirds the band D rate and those in band H pay twice the band D rate. While councils are able to choose the council tax rate they are not able to change the relativities between bands

**Table 1 Council tax bands in England, Scotland and Wales, plus the Council Tax billing ratio**

Band	Property Value:			Council Tax billing ratio
	England (April 1991 prices)	Scotland (April 1991 prices)	Wales (April 2003 values)	
A	Up to £40,000	Up to £27,000	Up to £44,000	6/9
B	£40,001 to £52,000	£27,000 to £35,000	£44,000 to £65,000	7/9
C	£52,001 to £68,000	£35,000 to £45,000	£65,000 to £91,000	8/9
D	£68,0001 to £88,000	£45,000 to £58,000	£91,000 to £123,000	1
E	£88,001 to £120,000	£58,000 to £80,000	£123,000 to £162,000	11/9
F	£120,001 to £160,000	£80,000 to £106,000	£162,000 to £223,000	13/9
G	£160,001 to £320,000	£106,000 to £212,000	£223,000 to £324,000	15/9
H	Above £320,000	Above £212,000	£324,000 to £424,000	2
I	n/a	n/a	Over £424,000	21/9

Source: England: Table 2.2c of DCLG (2006), Local Government Finance Statistics England No. 16 (<http://www.local.odpm.gov.uk/finance/stats/lgfs/2005/lgfs16/h/lgfs16/chapter2.html#b>); Scotland <http://www.scotland.gov.uk/library3/localgov/ctvb-00.asp>. Wales: <http://new.wales.gov.uk>

Across England two-thirds of properties are in bands A to C, with one quarter of all properties in the lowest band. In contrast less than one tenth fall in the top three bands. As a result while the average Band D rate in 2006–07 was £1,268 the average bill was actually £1,056. The distribution of properties across bands is subject to dramatic regional variation – 58% of properties in the North East fall into band A, compared to just 3% in London. This is despite the fact that 1991 was not a year in which house prices in London were particularly high relative to the rest of England: indeed since 1991 house prices have, on average, grown considerably more quickly in London than across the rest of England. A revaluation in England was begun so that from April 2007 council tax bands would have been based on April 2005 prices. However it was subsequently abandoned. While in principle a revaluation would be revenue neutral it would create many losers due to the lack of uniformity of house price growth since 1991.

#### *Business rates*

Business rates – or National Non-Domestic Rates – are levied on the annual rateable value (i.e. market rent) of the property occupied by business. In 2006–07 the rates were

set at 43.3% in England, 45.3% in Scotland and 43.2% in Wales.<sup>25</sup> Unlike council tax rateable values have been updated every five years with transitional arrangements smoothing gains and losses from the old to the new valuations. The last revaluation which came into effect in April 2007 is based on the estimated value at April 2005. Some types of property are exempt or qualify for a reduced rate – for example unoccupied buildings, agricultural land and rural shops, and a reduced rate applies to businesses with a low rateable value. Charities receive a reduction or exemption in business rates. While formally aggregate business rate revenues are allocated to local authorities on a per capita basis in practice this hypothecation is not binding as other grants from central government to local authorities take the business rate allocation into account. Business rates are deductible for Corporation Tax purposes.

The Treasury forecasts that in 2006–07 it will raise £21.5 billion (1.6% of national income).

#### *Child trust fund.*

The child trust fund provided for by the Child Trust Funds Act 2004 is intended as a new long-term savings and investment account for children. Its aim is to ensure that all children have a financial asset behind them when they reach 18 and to encourage a savings culture for families and children. All children in the UK born after 31 August 2002 will have a child trust fund account and receive an initial government payment of £250. There are higher payments for those being looked after by local authorities or in households with income below the income threshold for child tax credit (£14,155 for 2006–07). The Government is consulting on making a further payment at age 7 into all child trust fund accounts and also on the issue of a further payment at secondary school age. Payment is by means of a voucher which parents can use to open an account of their choice with a participating financial provider. Children, parents family and friends as well as businesses and community groups are able to contribute up to £1,200 pa to each account. No income tax relief is given on such a payment and such contributions by individuals are subject to the normal inheritance tax rules (so will use up the annual exemption or be exempt as normal expenditure out of income and otherwise be a PET).

On reaching 16 a child may manage his own child trust fund account but there be no access to the money until he reaches 18 at which point he can use the money as he chooses.

Neither child nor account provider is liable for any income tax on the income from the child trust fund savings and interest etc may be paid gross to the account provider. Contrary to normal rules income from such an account is not deemed to be that of the parent while the child is a minor even if the parent has contributed to the account. There is no capital gains tax on a disposal of account investments. Capital losses on the child trust fund account are not deductible against gains realised by the child personally on other investments held outside the child trust fund.

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<sup>25</sup> As with council tax Northern Ireland has a different system.

## **Transactions taxes**

### *Stamp duty land tax*

The purchaser of land and property is liable for stamp duty land tax. For residential property this is set at 1% of the total value of the property if the property is worth between £125,000 and £249,999; 3% if worth £250,000 to £499,999 and 4% if worth in excess of £500,000. The appropriate rate of duty applies to the whole purchase price, including the part below the relevant threshold. A slightly higher initial threshold of £150,000 applies to residential property in certain designated deprived areas. Non-residential property is also subject to stamp duty land tax, again with a higher initial threshold of £150,000.

There is no SDLT payable on gifts and hence transfers of wealth are effectively exempt. The only exception is if land is transferred to a connected company owned by the transferor.

### *Stamp duty on shares and bonds*

For shares and bonds, there is no threshold and stamp duty is levied at 0.5% of the purchase price on transfers of shares in UK registered companies. There is no stamp duty on gifts of shares.

The UK Treasury estimates that stamp duties will raise £12.7 billion in 2006–07 (1.0% of national income). In 2005–06 two-thirds of the revenue raised came from sale of land and property and one-third from the sale of shares and bonds.