

TIM CRAWFORD ARGUES THE CASE FOR INCREASING THE THRESHOLD FOR INHERITANCE TAX.

Legacy liabilities

The first baby boomers (those born in 1946, in the aftermath of World War II) turn 60 this year and begin to retire. Numbering 15.8 million people or 27% of the total population, the baby boomers represent a significant part of today's society and will play an important part in the intra-generational transfer of housing wealth that is to come.

More baby boomers (78%) own their own home than any other UK age group. In addition, baby boomers have witnessed an extraordinary transformation in British society: the rise of owner occupancy. In 1946, an estimated 31% of households owned their own homes. By 2001, this number had more than doubled to 70%.

The creation of a property-owning society has significant implications for the role of housing as a source of inherited wealth. Housing accounted for 49% of the total value of all estates in 2002/03, up from 36% in 1997/98, according to Her Majesty's Revenue and Customs (HMRC). We estimate that this trend will now accelerate as baby boomers retire and pass on their assets to subsequent generations.

We also estimate that housing assets valued at £360bn in today's money will pass from one generation to another over the next 15 years. This transfer of housing wealth will be the largest of its kind ever recorded in the UK.

DOUBLING THE INHERITANCE Our projections suggest that the value of housing assets inherited every year will more than double from £14bn in 2002/03 to £32bn in today's money by 2019/20.

On these calculations 60%, or £32bn, of the total value of all estates (£54bn) in 2019/20 will be accounted for by housing. In addition, the number of estates incorporating property assets is expected to increase from 104,950 (or 59% of the total) in 2002/3 to 115,347 (65%) in 2019/20.

The impact of the forthcoming transfer of housing wealth will not be spread evenly across the country.

Our projections suggest that the south of England will account for 54% (£17bn) of the total value of residential housing inheritance by 2019/20. Most of the other regions will have more modest shares. Wales is expected to have the lowest share (4%, or £1bn); the North West (10% or £3bn) will have the highest share of all the regions outside the south.

HOUSING ACCOUNTED FOR 49% OF THE TOTAL VALUE OF ALL ESTATES IN 2002/3, UP FROM 36% IN 1997/8. THIS TREND WILL NOW ACCELERATE AS BABY BOOMERS RETIRE AND PASS ON THEIR ASSETS TO SUBSEQUENT GENERATIONS.

Executive summary

- In the last financial year the government collected £3.3bn in inheritance tax and projects to rake in £3.6bn from the tax in this financial year. Over the past five years alone there has been a 49% rise in government revenue from inheritance tax.
- In 1996 only 15,000 estates paid inheritance tax. By March 2004, according to the latest available data, the number of estates paying inheritance tax had more than doubled to 30,451, and the government's own estimates put the number of estates paying inheritance tax this financial year 22% higher at 37,000.

THE AVERAGE PRICE OF A DETACHED PROPERTY IS ABOVE THE INHERITANCE TAX THRESHOLD OF £285,000 IN BOTH LONDON (£640,499) AND THE SOUTH EAST (£403,758). NEARLY ONE IN THREE (29%) DETACHED PROPERTY SALES IN THE UK COST MORE THAN £285,000.

These inheritance wealth projections have important ramifications for inheritance tax, especially in the context that the number of estates paying inheritance tax is rising, as is the number of residential properties valued above the inheritance threshold (the tax threshold has not kept pace with house price inflation).

The last time there was a significant increase in the inheritance tax threshold was back in 1996 when it was raised to £200,000 from £154,000. In that year only 15,000 estates paid inheritance tax. But by March 2004, according to the latest data, the number of estates paying inheritance tax had more than doubled to 30,451 and the government's own estimates put the number of estates paying the tax this financial year (2006/07) another 22% higher at 37,000.

According to HBOS data, over the past 10 years house prices have risen by 179%, compared with an 85% increase in the inheritance tax threshold. We calculate that the current inheritance tax threshold of £285,000 would now be £430,000 if it had been increased in line with house price inflation over the past decade.

At present, the inheritance tax threshold is planned to rise only very gradually to £325,000 by 2009/10 as announced by the Chancellor in his spring Budget.

ABOVE THE THRESHOLD The real problem behind the current level of the inheritance tax threshold is that more and more houses are now worth more than the threshold for the tax, which points to further rises in the number of estates potentially liable for the tax in

the future. There are now 1.5 million properties in the UK, representing 8% of all owner-occupied properties, that are valued at more than £285,000 (the current inheritance tax threshold).

By 2020 around 4.2 million properties, or 20% of all owner-occupied properties, could be valued above the threshold. In our calculations we have assumed that after the scheduled threshold increases up to 2010 the threshold will increase in line with retail price inflation (which is the broad long-term trend for the threshold), while house prices rise in line with the long-run real historical average of 4% per year.

Given this scenario and the likely increase in inherited housing wealth, the revenue collected by the Exchequer from inheritance tax could rise to £5.5bn a year in today's money by 2020. That is up 244% from the £1.6bn the Exchequer received in 1996, the last time the threshold for inheritance tax was raised significantly.

Already there has been a significant increase in the revenues generated by inheritance tax. In the first half of this year inheritance tax revenue totalled a record £1.7bn, up more than £200m on the first half of last year. Significantly, the revenue collected in the first half of 2006 matches the revenue collected over the full financial year 1997/98, only eight years ago.

In the last financial year the government collected £3.3bn from inheritance tax revenue, and it projects £3.6bn in inheritance tax revenue this financial year. In the past five years alone there has been a 49% rise in inheritance tax revenue.

We believe the government should raise the inheritance tax threshold to £430,000 to reflect the rise in house prices in the past decade and move back to a situation where only a small minority of very high net worth estates pay inheritance tax. While the government has scheduled some increases in the threshold for the next few years, there is an immediate need to increase the threshold by £145,000.

SMALLER ESTATES CAUGHT IN THE NET If nothing is done, an increasing number of smaller estates will pay inheritance tax and account for a larger share of total inheritance tax revenue. In 1998/99 estates valued at more than £2m generated 23% of total inheritance tax revenue. By 2003/04 this had fallen to 19% or £526m. By contrast, estates valued at less than £500,000 accounted for 25% (£683m) of total inheritance tax revenue in 2003/04. The number of estates with a value of less than £500,000 paying inheritance tax rose by 75% (to 21,750) over the five years to 2003/04. These small estates now account for 71% of all estates paying the tax.

Chart 1. Death duty rake-off in the UK housing market



ESTATES VALUED AT LESS THAN £500,000 ACCOUNTED FOR 25% (£683M) OF TOTAL INHERITANCE TAX REVENUE IN 2003/04. THE NUMBER OF ESTATES WITH A VALUE OF LESS THAN £500,000 PAYING INHERITANCE TAX ROSE BY 75% (TO 21,750) OVER THE FIVE YEARS TO 2003/04.

Highlighting the extent of the inheritance tax problem is the fact that the average price of a detached property is above the inheritance tax threshold of £285,000 in both London (£640,499) and the South East (£403,758). In fact, last year nearly one in three (29%) detached property sales in the UK cost more than £285,000.

The average price of a semi-detached property in London (£362,485) is also above the inheritance tax threshold, as are the average prices of a London terrace (£335,456) and a London bungalow (£304,659).

Delving deeper, the average house price is above £285,000 in 10% of English towns (48 out of 482). This is two and a half times the number five years ago when only 4% (19) of towns had an average house price above the then threshold of £242,000.

More than one-third of London boroughs (13 out of 32) have an average house price above the threshold, compared with less than one-quarter in 2001 (7 out of 32).

Almost one in five towns surveyed in the South East (33 out of 169) have an average house price above the threshold against less than one in 10 in 2001 (12 out of 169).

The London boroughs with the highest proportion of sales above the tax threshold are Kensington & Chelsea (84%) and Westminster (72%). The towns with the highest percentage of sales above the threshold are Gerrards Cross (82%), and Weybridge (68%). Ilkley in West Yorkshire has the highest proportion (36%) outside the south of England.

Given these figures it is clear that inheritance tax is a real issue in the south of England. About 40% of taxpayers, accounting for half of inheritance tax revenues, reside in London and the South East, according to two special exercises carried out by the HMRC.

The failure of the inheritance tax threshold to keep pace with house price inflation has created a problem. In addition to raising the inheritance tax threshold to £430,000, we call on the government to make a commitment to link the threshold to house price inflation in the future. We estimate that this change would cost the Exchequer approximately £1bn a year in lost revenue.

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