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Inheritance Tax: Could it be used to fund long-term care?

James Lloyd

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Executive Summary

Inheritance tax has become a popular solution among stakeholders, if not the wider public, to the historic challenge of how to fund older people's long-term care, particularly as a model that is 'fair' to younger cohorts. However, although relatively easy to administer, the model does confront problems in addition to lack of public support. The tax would make social care revenue streams highly vulnerable to fluctuations in property prices. With up to 90% of estates potentially liable for the new tax, many households would likely move wealth around in order to reduce their liabilities, casting uncertainty on how much revenue would be generated. A form of 'Carer Penalty' would result for carers who gave up work - and income - to provide care to those whose estates would be liable for the estate tax.

In recent times, the proposal to implement a new inheritance tax (IHT) has arguably become the most popular option among social care stakeholders regarding how to fund 'universal free care', and thereby eliminate the use of means-testing in the system for public funding of care and support.

This development has come about in response to growing awareness of intergenerational disparities in household wealth, and recognition that any reform that relied on general taxation would arguably place an unfair burden on younger cohorts.

In the 2010-2011 tax year, estates valued at more than £325,000 are liable for IHT at a rate of tax is 40% on the value of the estate above this threshold.

The key design choices for a new IHT for care relate to: thresholds and rates; whether a new IHT is notionally 'hypothecated'; the incidence of the IHT for care on estates by age of death; whether caps on IHT bills would be introduced to prevent 'over-payment', i.e. bills that exceeded the amount individuals would have pay to insure themselves through other means; and, the name of a new IHT for care.

The advantages of an IHT for care and support include: simplicity and communicability; potentially sufficient new revenue; intergenerational fairness; progressivity; scalability of existing probate system; the channelling of the housing wealth of the older cohort into long-term care funding system; effective use of household resources; and, a potentially universal solution.

The disadvantages of an IHT for care and support comprise: weak political acceptability; the 'totemic' nature of IHT; the so-called 'Carer penalty' posed by an IHT on the estates of those who relied only on informal care; the likely behavioural response by up to 90% of older households brought into the IHT net of transferring wealth in order to lower exposure to the new IHT; affordability of IHT bills given their incidence on the value of unsold homes; the 'lumpiness' of IHT as a revenue stream for the social care system; sensitivity of IHT, and thereby social care funding, to fluctuations in house prices; the risk that future governments would divert revenue from an IHT to other areas of public expenditure; long-term sustainability given trends in home-ownership; and, incoherence with the policy objective of improving the affordability of home-ownership for younger cohorts.

Potential variations of an IHT for care include: exemptions for recipients of informal care; IHT contributions to a social insurance fund; and, the use of an estate-charge, rather than a tax, to fund care and support.

1. Introduction

Changing the UK's inheritance tax framework has become a popular idea among social care stakeholders as to how to fund universal free care and support in England and Wales...

The funding of long-term care remains one of the biggest public policy challenges confronting Westminster policymakers.

In a policy debate that has run continuously for over a decade, many stakeholders had previously favoured a generic tax-based solution to this challenge, built around universal free care for all funded through general taxation. This was the substantive recommendation of the Majority Report of the Royal Commission on the Funding of Care in 1999.

However, in recent years this 'general taxation' model has been subject to increasing examination and critique, particularly in the context of intergenerational inequalities in household wealth,[1] and a growing realisation that its implementation would effectively see an historic new welfare entitlement granted to the so-called 'baby-boomer' generation – the wealthiest cohort in history – with the financial burden falling principally on the younger, working-age generation, whose long-term financial prospects appear substantially bleaker.[2]

In this context, many stakeholders to reform of long-term care funding have shifted to favouring a funding model still built around universal state-funded free care, but with the extra revenue required derived from a new tax on the value of estates, rather than general taxation. On this approach, a large part of social care funding would – as now – continue to be funded out of general taxation. However, the *extra* revenue required to enable the implementation of universal free care would be derived from a new tax on the value of estates.

In the months preceding the 2010 General Election, when the issue of long-term care funding reform achieved high-profile political visibility for the first time, it is reasonable to speculate that an "inheritance tax to pay for care" was the most popular option among many social care stakeholders,[3] even if the public at large remained broadly hostile to such an idea. Indeed, research with older people has, perhaps unsurprisingly, shown a preference for a universal system funded through general taxation.[4]

Inheritance Tax: Could it be used to fund long-term care?

Despite its popularity within the social care community, there has been limited detailed public scrutiny of the advantages and disadvantages of deploying changes to the inheritance tax framework in order to abolish the means-test in the social care system of England and Wales, thereby enabling universal free care for all, albeit with the retention of a carer-sighted needs-assessment.

This discussion paper therefore attempts to fill this gap, as a contribution to policy debate on the future of funding long-term care for older people.

In the next chapter, the principal design choices around implementing a new inheritance tax (IHT) for care are identified and explored.

In the third chapter, the advantages and disadvantages of IHT as a model to fund long-term care are examined in detail.

The fourth chapter explores some key variants to the model of an IHT for care that are possible. The Conclusion draws out key findings for policymakers.

Multiple different specifications for an IHT for care are possible, and a new IHT could be used for different social care related purposes, rather than just for funding universal free for all. However, for the sake of simplicity, this report deploys a working assumption that a new IHT would be used to fund universal free care, i.e. the existing means-test deployed in the public

However, there has been limited policy debate as to the pros and cons of such an approach...

funding system would be abolished, although needs-assessments would continue to be 'carer-sighted'.

This is because universal free care has not only been the system that stakeholders have conceived as that which would result from an IHT for care, it is unlikely that the implementation of an IHT for care could be associated with the retention of means-testing in the social care system, if the public were persuaded to support a new IHT. In short, the abolishment of means-testing would likely represent the minimum prize that politicians would have to offer to the older cohort in order to achieve popular support.

Key points:

- In recent times, an IHT to fund care and support has arguably become the most popular option among social care stakeholders regarding how to fund 'universal free care', and eliminate the use of means-testing in the system for public funding of care and support.
- This change has come about in response to growing awareness of intergenerational disparities in household wealth, and recognition that any reform that relied on general taxation would arguably place an unfair burden on younger cohorts.
- However, despite the attention it has received, there has been little public scrutiny of the pros and cons of changing the IHT framework to enable the imposition of universal free care.

2. Design choices for a new tax on estates

Policymakers considering a new IHT for care and support would confront a series of design choices, in particular, around the thresholds and rates of a new IHT...

This chapter explores the various design choices posed by the idea of implementing changes to the inheritance tax framework in order to fund universal free care for all.

It begins with an overview of the current inheritance tax (IHT) framework, and then explores design issues focusing on: thresholds and rates; hypothecation; incidence by age of death; caps on IHT bills; and, the name of a new IHT for care.

Inheritance Tax: The current picture

For the 2010-2011 tax year, estates valued at more than £325,000 are liable for inheritance tax (IHT). The rate of tax is 40% and applies to the value of the estate above this threshold. This means that an estate of £370,000 would have a tax of 40% charged on £370,000 minus £325,000, i.e. £45,000. The total IHT bill in this example would be £18,000.

However, since October 2007, any unused portion of the tax-free allowance up to £325,000 has been transferable to a spouse or registered civil partner, effectively resulting in an exemption of £650,000 in 2010-11 for many households. Further exemptions to IHT apply to:

- Any gifts made to a 'qualifying' charity.
- Some relief is available if the deceased owned a business, farm, woodland or National Heritage property.

IHT is payable by different people in different circumstances. Typically, the executor or personal representative pays it using funds from the deceased's estate. In most cases, IHT must be paid within six months of the end of the month in which a person died. After this point, interest is charged on any amounts outstanding. If the value of an estate is tied up in property such as a house, the tax can be paid in annual instalments over ten years.

The value of a share of a house or land that's owned jointly, and which may be subject to IHT, depends on the size of the share that the person holds and who the other owner is. If the deceased person jointly owned a house or land with a spouse or civil partner, the value of the deceased person's share is used in the valuation of the estate.

‘Probate’ is the process of handling the estate of someone who has died, and gives the executor the legal right to distribute the estate according to the deceased's wishes. IHT forms have to be completed as part of the probate process, even if no inheritance tax is due. Executors apply for the grant of probate to have legal permission to distribute an estate. If the deceased died without leaving a will, a blood relative can apply for a 'grant of letters of administration', depending on a strict next-of-kin order of priority defined in the 'rules of intestacy'. This makes them the 'administrator'.

For the 2007-2008 tax year, official data shows that IHT was paid on 24,291 estates, representing around 10% of all estates subject to probate. The revenue generated for the Exchequer was around £3 billion.[5]

What are the principal design choices involved in changing the existing IHT framework in order to create a new IHT to fund long-term care?

IHT thresholds and rates

In designing a new IHT, the key choices are around the tax rate, and the thresholds at which it applies, i.e. on the whole amount or values above a certain level. The tax rate could also be altered at different thresholds. At present, a tax rate of 40% is applied to the value of estates above the threshold of £325,000.

The significant proportion of social care funding that would continue to derive from general taxation means that a new IHT could only be notionally hypothecated to fund care and support...

In effect, the IHT rate on estates of £1 to £325,000 is 0% (the 'nil-rate band').

A new IHT for long-term care could apply to all estates valued at £1 or above. Alternatively, a new 'tax-free allowance' could be created so that any new IHT only applied on the value of estates above a threshold of, for example, £20,000. The rate could also increase at different thresholds. For example:

£1 - £20,000	0%
£20,000 - £100,000	10%
£100,000 - £200,000	20%
£200,000 - £325,000	30%

Determining the thresholds and rates must take account of various considerations:

- *Complexity vs. simplicity* – the more new thresholds and rates created by an IHT for care, the greater the complexity of the resulting framework, making the tax harder for individuals to understand and increasing administrative costs.
- *Progressivity* – the extent to which the total effective tax rate should increase in line with the total value of a person's estate.
- *Revenue to be generated* – perhaps the most important consideration for designing a new IHT framework to fund universal free care would be the revenue required to enable this new entitlement. Although several studies have been undertaken to estimate the IHT framework required to fund universal free care and the abolishment of the social care means-test in England and Wales, these projections have not been widely circulated. Nevertheless, it has been suggested that universal free care in England and Wales would require a new IHT of 13% applied to the value of all estates above £20,000 and in addition to the existing 40% rate on the value of estates above £325,000 (thereby taking the effective top-rate to 53%). Such figures inevitably incorporate multiple assumptions, but may broadly be expected to generate the revenue that would be required to enable universal free care. It has been projected, again using multiple assumptions, that the cost of implementing free personal care for older people in England and Wales, incorporating public spending on Attendance Allowance, would be £14.6bn in 2015 per year rising to £21.6bn in 2026, compared to the £10.2bn cost of the current system.[6]

Hypothecated vs. non-hypothecated models of an IHT for care

In discussion of an IHT for social care, different conceptions of how an IHT for care would work are observable.

A *hypothecated* IHT for care would see the revenue generated by the new tax ring-fenced and allocated purely to expenditure on social care. Revenue generated from the IHT for care would be spent on social care and nothing else, and no other government departments would be able to lay claim to this revenue.

The UK has very few hypothecated taxes, with the Television License being one example, although policy debate regularly throws up suggestions for new hypothecated taxes, such as a 'green tax' on airplane tickets to subsidise investment in renewable energy sources. HM Treasury (HMT) has traditionally resisted hypothecated taxes, which reduce the scope of the available 'tax base' (potential sources of tax revenue) over which HMT has discretionary control as part of UK fiscal policymaking. The advantage of strict hypothecation, i.e. an untouchable funding stream wholly earmarked for a specific purpose, is that it provides a guarantee that the revenue would not be directed to other sources, which may increase the political acceptability of imposing a new tax with the public.

Policymakers would have to decide whether an IHT on the estates of younger people would disrupt the rationale of 'intergenerational fairness', and whether the new IHT should apply in Scotland...

A *non-hypothecated* approach to an IHT for care – the opposite of hypothecation - would see the new IHT, however it was labelled for presentational and political purposes, treated simply as an extension of the tax-base, with the new revenue coinciding with an expansion of public spending to fund universal free care. On this approach, the revenue generated by the new IHT would not be ring-fenced, but would coincide with a decision to fund universal free care in government spending reviews.

However, because any new IHT for care would only provide *part* of the funding for universal free care, with a large proportion, as now, continuing to come from general taxation, an IHT for care could not, by definition, be truly hypothecated. HMT would retain discretionary control over the non-IHT portion of public spending on social care, which it could raise or lower in response to changed political priorities and variations in the revenue derived from an IHT for care. As such, although a new IHT could be hypothecated, long-term care funding as a whole would not be, limiting the extent to which all revenue streams for social care could be categorised as hypothecated.

This provides a dilemma for the IHT model within policy debate as qualitative research with older people into attitudes to long-term care funding reform has found that ring-fencing – i.e. strict hypothecation - was "critical to the concept of risk pooling. The notion of 'ring fencing' was critical to the concept's appeal as there was considerable concern that the government may otherwise spend the money on something else."[7]

incidence of IHT by age and location

A key design choice around an IHT for care is whether the tax would apply to the estates of all individuals or just those who have died when aged over the State Pension Age.

This issue is important given that the key rationale put forward in debate for adopting an IHT for care is 'intergenerational fairness'. As such, it is debateable whether the estate of someone who died at a relatively early age, e.g. 35, should be liable to an IHT for care. Restricting the incidence of IHT to the estates of those who have died when of a specific age, e.g. at or above the State Pension Age, may also improve the political acceptability of an IHT for care as most of the adult population would be excluded, and working-age adults with dependent children would not be concerned about their offspring being confronted with an IHT bill in the event of their early death.

A further critical choice would be around whether a new IHT for care and support would apply to the estates of those who have died in Scotland. Given the current system of notionally free personal care in Scotland, the relatives of the deceased in Scotland might object to paying for a new IHT to fund an entitlement they already perceive themselves to have. However, if the new IHT did not apply to Scotland, this might encourage some families to attempt to game the system, with elderly individuals encouraged to change their registered address to that of Scottish relatives in order that their estate would not be subject to the new IHT.

Caps on IHT bills

Most redistribution through the tax system occurs relatively covertly: most individuals have only a rough idea of how much they pay in total in different forms of tax (income tax, VAT, National Insurance, capital gains, etc.), and even less conception of how much they receive back from the state in entitlements or services, whether in the current year or over a lifetime.

However, most individuals would be able to calculate their liability for an IHT for care, and many may also become aware of the actual value of the entitlement they receive.

A critical decision would be whether to 'cap' the bills under a new IHT to limit the extent of individuals 'over-paying' for an entitlement that would cost less if obtained through private insurance...

The mean expected average lifetime cost of personal care for someone aged 65 is £22,300 for a man and £40,400 for a woman.[8] Men and women whose estates would be liable for bills arising from an IHT for care that exceeded such amounts may question, and ultimately oppose, the level of IHT their estate would be liable for. This would particularly be the case if someone confronted a very large IHT bill, such as £100,000, labelled as a 'levy' or 'contribution' to pay for long-term care.

Although at present no insurance companies offer pre-funded insurance for long-term care, insurance companies might nevertheless highlight that some individuals were being compelled to pay more under an IHT for care than they would for a private insurance product providing the same level of funding.

For these reasons, a key design choice for an IHT for care is whether total bills arising from a new IHT would be capped. Put another way, should an IHT for care expect individuals to pay more through the tax than they would for a similar entitlement obtained via a private insurance product (were such products available)? Being an issue of redistribution, this is clearly a highly political question.

If caps on tax bills under an IHT for care were not imposed, the new IHT would arguably represent the first time in the UK that individuals would be compelled to pay a tax, the personal cost of which would be easy to calculate, and for which they would also be able to put a price on the benefit they receive, with many individuals able to identify how many thousands of pounds they were expected to 'over-pay'. There is no evidence as to whether or not such an outcome would be politically tenable.
If caps were imposed on tax bills arising from an IHT for care, this would have implications for how progressive the IHT for care framework would be – wealthier individuals may end up paying a smaller proportion of their estate than households of modest wealth – and for the design of thresholds and tax rates for an IHT for care, to ensure revenue is adequate. A cap on total tax bills for an IHT for care would mean that less wealthy households would have to accept higher tax-rates.

Name

A final key design choice around a new IHT for care would be its name. This is particularly important given the widely noted unpopularity of any form of estate taxation, and the argument put forward by proponents that explicitly and clearly earmarking an IHT for care – linking the tax with the entitlement - would be desirable to make this tax change politically feasible, rather than simply redesigning the current IHT framework to increase the revenue it generates.

Identifying the right name could be difficult. Although names such as 'care levy' have been put forward, a name that was too 'narrow' or specific could subsequently create problems, for example, around the use of an IHT to fund cost-effective preventative measures and non-traditional forms of support, such as telecare.

However, it is worth underlining that ultimately, any government would have negligible influence on what members of the public actually called a new IHT for care, regardless of its official name. The common use of the phrase - "death tax" - in news coverage of the long-term care funding debate around the start of 2010 suggests this would in fact become the default name.

Key points:

- For the 2010-2011 tax year, estates valued at more than £325,000 are liable for inheritance tax (IHT). The rate of tax is 40% and applies to the value of the estate above this threshold.

Any name ascribed to the new IHT by policymakers would risk being supplanted by the phrase 'death tax'...

- The key design choices for a new IHT for care relate to thresholds and rates; hypothecation; incidence by age of death and location; caps on IHT bills; and, the name of a new IHT for care.

3. Evaluating an inheritance tax to fund care and support

Key advantages of a new IHT for care and support include relative simplicity, intergenerational fairness, and the potential for upscaling the existing probate system...

The previous chapter reviewed the key design choices around implementing a new IHT to fund universal free personal care.

This chapter explores the advantages and disadvantages of this model in the context of a wide-ranging and ongoing policy debate regarding how to fund long-term care that has generated multiple potential models.

Advantages of an IHT for care and support

What are the *advantages* of implementing a tax on the value of estates to fund care and support?

- Simple and communicable

Long-term care funding reform is a complex topic, and reform has been held back by a lack of public understanding of the issue. Given this outcome, and the complexity of various models put forward in debate, it would be desirable for long-term care funding reform to be built around a policy that is easily understandable and communicable to the wider public.

As an intuitive concept, a new IHT to fund care and support is relatively simple and communicable. However, this point should not be overstated: once transfer rules, exemptions and delayed payments are considered, the practical considerations of an IHT could be relatively difficult to explain members of the public.

- Sufficient revenue stream

Depending on how IHT thresholds were set, an IHT for care could drive sufficient revenue into the social care system, such as to enable the abolishment of means-testing, and the creation of a 'fully-funded' system with associated positive outcomes related to care and support.

- Intergenerational fairness

Compared to funding universal free care through general taxation, a new IHT for care would have the property of intergenerational fairness, as it would not shift the burden of paying for care of the older generation on to the younger, working-age population. Instead, those members of the older generation, including over 80% of the baby-boomer cohort who own their own home, would effectively be funding their own care and support through a mandatory tax that pooled the risk of needing care among them.

- Progressive

Even as a flat-rate tax, an IHT for care would see the amount that individuals contribute via their estate to a new long-term care funding system proportional to their wealth: richer households would contribute more than poorer ones. Progressive contributions are only possible under an IHT for owing to its mandatory nature, in contrast to long-term care funding models built around voluntary contributions.

- Scalability of existing probate system

The feasibility of implementing an IHT for care would is high relative to some potential other long-term care funding models. As described above, IHT forms have to be completed as part of the current probate process by the executor regardless of whether IHT is liable. Nevertheless, under an IHT for care, around 90% of estates would be liable for tax bills, payment of which would in many cases have to be deferred. As such, the administrative task involved in implementing the new IHT would be significant.

- Brings housing wealth into long-term care funding system

The principal public spending obligations toward the older population are the State Pension and the

The key disadvantage is the low political acceptability of an IHT for care among the public, which is arguably worse than for other 'compulsory' funding options, given the totemic nature of IHT...

National Health Service (NHS). In the context of an ageing population, the fiscal pressure resulting from these existing welfare obligations will grow. However, the decline in the UK elderly support ratio has coincided with an unprecedented negative fiscal outlook for public spending that has resulted, for example, in the decision by the House of Commons to raise the cap on university tuition fees.

In this context, a number of policy analysts have identified the considerable and unprecedented housing wealth of the older population as the most likely source of significant new funding for the social care system. The rate of property ownership among those aged 60-75 is around 85%, and 77% among those aged 75-85.[9] Median net household property wealth among those aged 75+ is around £180,000, and even higher among those earlier in retirement. As such, there is sufficient average per capita housing wealth within the older population to fund a highly generous social care system, such as universal free care. In this context, a model of long-term care funding that is able to direct this housing wealth into the social care system would be desirable, and an IHT for care would achieve this.

- Effective use of household resources

Under the IHT model, the wealth individuals would be using to insure against the costs of long-term care – principally their housing wealth – is effectively of no use to them after death. This contrasts with some other models for funding long-term care, which require income-based contributions during life that would directly reduce expenditure and living standards. In this sense, IHT could be seen as an effective use of household resources.

- Universal solution

Commentators on the long-term care funding debate have in recent years recognised that reforms would not necessarily have to involve a single funding model that would apply permanently to every successive cohort,[10] and this insight also applies to a potential IHT for care and support: alternative arrangements could be developed and implemented for subsequent generations.

Nevertheless, an IHT for care could be considered a permanent and therefore universal solution that would apply to multiple generations, albeit with tweaks to thresholds and rates likely to be required to reflect trends in the value of estates and demand for care associated with trends in longevity, morbidity and the availability of informal care.

Disadvantages of an IHT for care and support

What would be the *disadvantages* of a new IHT framework to fund universal free care?

- Political acceptability

Inheritance tax is generally acknowledged as one of the least popular forms of taxation in the UK. As such any policy proposal that involved increasing the incidence of IHT, regardless of whether it is linked to wider entitlement to care funding, would be likely to confront considerable public hostility.

- Totemic nature of IHT

The 'totemic' nature of IHT could make it more problematic as a solution to long-term care funding than other 'compulsory' models put forward in debate.

Various long-term care funding models built around mandatory payments from households (taxes or compulsory contributions) can be conceived, all of which would represent a significant challenge to politicians to promote such reforms to a potentially sceptical public.

A difficult issue to resolve would be the 'carer penalty' – individuals forgoing earnings to provide informal care, only to see their inheritance reduced in the name of an IHT for care and support...

However, compared to other approaches, a mandatory tax on the value of estates will be particularly challenging to present to the public, given the 'totemic' nature of IHT, and the likely 'heat and noise' that would be generated.

Unlike other 'compulsory' models, some stakeholders would likely oppose a new IHT for care simply because it is a tax on the value of estates, without actually engaging with the issue of how to fund long-term care and the merits of an IHT approach.

Conversely, an IHT for care would be likely to receive support from some quarters just because it involved an increase in the incidence of IHT, rather than because it was viewed as a superior approach compared to alternative models that achieve the same end.

As such, compared to other 'mandatory' models of long-term care funding that involve compulsory payments, an IHT for care would be more difficult to use as the basis for a conversation with the public about the necessity of reform.

- 'Carer penalty'

An IHT for care would be likely to face accusations of unfairly penalising those have provided informal, unpaid care.

Although frequently overlooked by policy discussion on long-term care funding, the majority of care across the population is provided as 'informal', unpaid care by family and kin. Among the 50+, 33.8% report receiving informal care, 3.8% receive home care purchased out of pocket (although 54% of this group also receive informal support), and 3.9% report receiving home care paid for by the state.[11]

At present, some informal care provided to individuals who are too wealthy to be entitled to public support is likely to comprise care provision under duress, as family members feel compelled to provide informal care rather than see a person's wealth run down to pay for care out-of-pocket, given a relative's exposure to potential 'catastrophic costs'.

If an IHT for care were used to abolish the means-test in the social care system, this would ensure that – at least in theory – all informal care provision was voluntary and sustainable, with public support for care allocated on the basis of a 'carer-sighted' needs-assessment by local authorities, used to confirm that a family carer is willing and able to provide care. As such, an IHT for care would result in what would arguably represent the largest possible improvement in policy toward informal carers: ensuring that all informal care was entirely voluntary and did not simply reflect the use of means-testing to allocate public support.

Nevertheless, the wide prevalence of informal care provision could result in some unintended consequences following the implementation of a new IHT to fund care and support.

Informal carers are predominantly from older age groups. Although nearly half of carers are aged 65 or over, 44% are aged 45-64 and the remaining 7% are aged 18-44. Two-thirds are female.[12] Many informal carers give up paid work in order to provide informal care. Many other carers experience a significant toll resulting from unpaid care provision, even while they willingly provide care. Informal care provision is frequently associated with negative financial, psychological, physical and social outcomes for informal carers.

Although it is rarely discussed publicly, many families reach explicit and implicit agreements regarding informal care provision, in which inheritance transfers are effectively used as compensation for providing informal care, as well as to potentially incentivise it.

Given so many estates would be liable for the IHT, policymakers confront uncertainty as to how many households would reduce their exposure - and the revenue generated - by moving wealth around...

However, even in situations in which a person had relied entirely on informal care provided by a family member, thereby saving the Exchequer many thousands of pounds, an IHT for care would be payable on their death. In such a situation, many informal carers may potentially consider it highly unfair and unreasonable for the estate of the person they provided care for to be subject to a new IHT explicitly linked to funding care and support.

The perverse consequences would be greatest for those who give up paid employment to provide informal care. Even under a reformed system involving universal free care, such carers would save the Exchequer significant expenditure. However, in leaving the labour market, or reducing hours of paid work, a carer might effectively forgo income of, for example, £50,000 over two years. In this way, some carers would be subject to a double financial 'penalty': loss of earned income through informal care provision, and loss of inheritance to which they may feel entitled.

- Behavioural response by households

An IHT for care would inevitably change household behaviour, and would likely see many households move their assets in order to reduce their tax liability under a new IHT for care.

If an IHT for care had been liable on every estate worth more than £20,000 in 2007-2008, then of 270,639 estates in that tax year, around 242,046 would have been liable for IHT,[13] assuming no households had moved asset to reduce their exposure to IHT. As such the reach of IHT would have extended from around 10% of estates to around 90%.
More generally, although the distribution of wealth varies by age, data from the UK Wealth and Assets Survey shows that average total household wealth, excluding pension wealth, at the lowest quartile of the distribution among those aged 75-84 was £40,400, and £78,100 among those aged 65-74.[14] This suggests that at an absolute minimum, 75% of the pensioner population would benefit from moving their assets around in order to reduce their liability to an IHT on estates worth over £20,000.

In short, a far greater proportion of the population would be incentivised by an IHT for care to move wealth in order to lower the value of the IHT bill payable on their estate.

How might households move wealth? Liquid wealth such as savings and investments can be transferred to younger family members. Of the £62 billion left in estates in 2007-8, £23.7 billion (38%) was as highly liquid cash and securities.[15]

Illiquid property wealth is clearly harder to transfer. Nevertheless, potential liabilities to IHT can be reduced by transferring ownership to adult children, or making children co-owners, such that the 'share' of a property belonging to an older family member is repeatedly diluted, reducing their exposure to IHT. Some older households may lower the potential IHT bill on their estate by simply downsizing their home and spending any proceeds on themselves or family members.

Moving wealth around in this way is to some extent limited by rules on lifetime gifts, for example, from elderly parents to adult children. Gifts up to the value of £3000 per year are allowed. However, the value of any gifts above this amount may be liable for IHT if they were made in the seven years preceding someone's death.

Nevertheless, there is considerable uncertainty regarding the effectiveness of these rules: the investigatory and policing powers of HM Revenue & Customs (HMRC) are finite, and it is unknown to what extent families are already in fact engaged in wealth transfers to lessen their exposure to IHT.

A new IHT for care and support would make social care revenue streams highly sensitive to fluctuations in property prices...

Although steps could be taken to tighten up the application of IHT rules in relation to such lifetime 'inter-vivo' transfers, this becomes problematic if the majority of the older population – for example 90% - engage in such transfers. Given that under an IHT for care, for every £100 transferred, most families would save around £13 in tax, there is a strong financial incentive to move assets. If the majority of those incentivised to transfer wealth did so, any new rules to stamp-down on this behaviour would become meaningless. Indeed, a new culture of family wealth transfers would likely result, with families engaging in estate planning many years in advance, and the use of new financial vehicles and trusts would be likely to emerge.

Crucially, the fact that the vast majority of the older population would be incentivised to take steps to reduce their exposure to an IHT for care creates significant uncertainty regarding what revenue would be derived from such a tax; it is difficult to predict with accuracy household behaviour under a scenario in which up to 90% of estates may be liable for IHT, rather than the current 10%. This may prove challenging if politicians were only able to secure consensus for an IHT for care on the basis of, for example, a 13% rate, but this rate proved insufficient to fund new entitlements in the face of widespread wealth transfers among families.

More widely, there may be a risk that an IHT for care would see households put undue pressure on older family members to move wealth in order to minimize exposure to an IHT for care.

Nevertheless, this potential for households to reduce IHT liabilities does need to be set against the current prevalence, also largely hidden, of behaviour to reduce 'charges' in the current social care system, i.e. the 'deliberate deprivation' of assets in response to means-testing by local authorities.

- Sensitivity to fluctuations in house prices

The majority of older people's household wealth comprises property wealth. Among the 75-84 age-group, property wealth comprises 98.5% of total net median household wealth excluding pension wealth.[16] Of the £62 billion of estates left in 2007-8, which includes the estates of the very wealthiest with significant cash and investments, around £32 billion (51%) comprised residential property wealth.[17]

As such, at least half of the revenue from an IHT for care and support would derive from the value of housing wealth, and most likely more, if an IHT for care saw many individuals transfer liquid wealth to other family members to lower the value of the IHT bill on their estate.

Revenues for funding care and support via a new IHT would therefore be heavily dependent on the investment performance of a single 'asset-class': residential property. In effect, an IHT for care and support would see that portion of social care funding derived from a new IHT heavily exposed to 'investment risk'. Social care revenue streams would be highly sensitive to fluctuations in property prices.

House price crashes may result from multiple causes, whether loss of confidence in the market among consumers, or external shocks, such as a freezing of liquidity in international capital markets, as was witnessed in the global 'credit crunch' that began in 2007.

If an IHT for care were strictly hypothecated and ring-fenced, the consequences of a sharp drop in house prices, for example, of 15% in 12 months, would in theory have to be passed on to social care expenditure, and could have severe consequences for social care users.

And various other factors could cause an IHT for care and support to fail to provide the revenue required to fund new entitlements...

However, as described above, genuine strict hypothecation for an IHT to fund care and support is effectively impossible. In the event of a house price crash, social care policymakers would look to the Exchequer to make up for any unexpected shortfalls in revenue from an IHT for care. However, reductions in house prices are commonly associated with slowing economic growth, declining tax revenues and a worsening fiscal outlook. As such, it is likely that there would be limited scope for the Exchequer to 'smooth-out' the exposure of social care funding streams to the 'investment risk' associated with being so closely dependent on the performance of house prices.

- 'Lumpiness' of revenue stream

In addition to fluctuations in house prices, other outcomes could potentially see the revenue derived from an IHT for care fail to meet expect outgoings.

Whatever the shape of a reformed social care funding system associated with an IHT for care, it would be desirable for revenue into the system to be smooth and predictable from year to year, whether the IHT for care was hypothecated or non-hypothecated.

However, a number of factors would drive variations from year-to-year in the revenue provided by an IHT for care, meaning that the revenue would be 'lumpy' in nature. For example, a particularly virulent winter flu bug that saw an up-tick in winter deaths among the elderly population would see the revenue from the new IHT increase, but then potentially decrease the following year in the wake of a mild winter.

This characteristic of revenue streams derived from IHT receipts can be seen in historic and projected data. More information on trends in IHT receipts by the Exchequer is contained in the Appendix.

- Long-term sustainability

Long-term trends in property ownership may affect the revenue stream generated by an IHT for care. Rates of property ownership vary across the life course, but also by cohort. Some commentators expect the current younger generation to subsequently display a lower rate of home ownership in retirement than the current baby-boomer cohort. As such, over several decades, the number of estates comprising property wealth could decline, putting downward pressure on the revenue generated by an IHT for care.

- Affordability of IHT bills

An IHT for care may leave surviving partners facing substantial tax bills in relation to property wealth that they struggle to pay. This issue would be particularly pertinent if an IHT applied to every estate, with limited transfer of exemptions within the current nil-rate band - e.g. a rate of 13% on the value of estates from £20,000 to £325,000 - and the tax applied to the value of jointly owned property wealth which was not sold on death owing to the fact that the surviving partner still resided there.

For example, median net household wealth – excluding pension wealth but including housing wealth – in the 75-84 age group is around £182,700.[18] Assuming a rate of 13% on the value of estates from £20,000 to £325,000, and that the transfer of exemptions was not allowed, an average household in this group that saw the death of a partner who owned 50% of household wealth would result in an IHT bill of £9,275.

Among those in the 75-84 age group who have financial wealth (which would be likely to include all home owners), median financial wealth, i.e. savings, investments, etc., is £11,300. This figure suggests a typical surviving partner could pay this bill outright leaving £2025 of financial wealth.

As a tax, an IHT for care and support would always be at risk of being diverted to fund other areas of public expenditure, reflecting the different political priorities of future governments...

Alternatively, under current rules, the value of the property related IHT bill could be paid in annual instalments over a period of ten years. The crucial change would be that under the IHT for care model, there would be a far wider incidence of a tax on wealth that was not being 'liquefied' when a person died, i.e. the value of a property that was not being sold. Widespread payment of IHT bills in instalments arising from any IHT on property wealth would be likely, and would create significant administrative costs.

However, it is important to note that such an outcome is not unique to the IHT for care model of long term care funding. Multiple models for funding long-term care that seek to bring the property wealth of the older cohort into the social care funding system also confront the challenge of making a claim on housing wealth that is yet to be realised through the sale of a home, because a surviving partner – or potentially other family member - is continuing to live in the property.

- Political-risk

A feature of any new long-term care funding settlement, including an IHT for care, is that no current government can guarantee that future governments will not change policy, in particular, by redirecting revenues from an IHT for care to other forms of public expenditure, reflecting changed political priorities.

The implementation of an IHT for care – whether pitched to the public as hypothecated or non-hypothecated - would likely require significant political capital to be expended by a governing party, as well as the existence of a cross-party consensus.
However, over time, even the most solid political consensus can weaken in the face of rival spending demands. This is particularly relevant for long-term care: public expenditure on social care for the older population must compete with rival claims by other types of spending on the older population, i.e. the State Pension and the NHS. In the face of an ageing population, public spending on all three will have to increase just to maintain current entitlements. However, unlike the State Pension and the NHS, public spending on social care is to some extent substitutable with informal care by households, and as such, frequently fares worse in government spending reviews. Arguably, it is this feature of social care that largely explains the current under-funding of the social care system.

As such, no matter how strong the political consensus that would see the implementation of an IHT for care, such an arrangement would nevertheless be loaded with 'political-risk', especially as policymakers face up to the fiscal consequences of an ageing population over the next two to three decades.

Although notions of political-risk may appear an abstract and prosaic consideration, qualitative research undertaken with older people regarding the use of assets to pay for care, such as through an IHT, reveals an acute awareness and concern that that a future government might divert money earmarked to pay for universal free care to spend on something else.[19]

Nevertheless, it is worth noting that this problem is not confined to an IHT for care, but applies to any tax-based funding model for long-term care, and reflects why many countries have sought solutions built around independent social insurance funds and private insurance.

- Policy coherence

Problems in public policy frequently arise from incoherent objectives across different policy domains.

It is a stated government objective to increase affordability of housing - in effect, to bring down the long-term cost of home ownership, whether through

An IHT creates potentially incoherent policy objectives: social care stakeholders and older people might resist new policy interventions to increase the affordability of housing for young people...

boosting supply, or through demand-side measures, such as those that have been explored by the Financial Services Authority (FSA), for example, greater regulation of the 'loan-to-value' ratio of new residential mortgages. This objective is of particular concern and interest to younger cohorts, many of whom have been 'priced out' of home-ownership, and given trends in mortgage size and deposit, are being compelled to pay an increasing proportion of their life course income on housing.

However, by linking funding for care and support closely to the investment performance (price) of residential property, policymakers would effectively be making the care of the most vulnerable people in society dependent on house prices continuing to be high relative to earnings. As such, decisive policy interventions to bring down house prices, or to hold down house price inflation consistently below growth in average earnings in order to increase affordability, would effectively undermine funding streams for social care. Were an IHT for care accepted by the 'baby-boomer' cohort, it is possible that popular opposition within this generation to policy measures to increase affordability of home ownership would be exacerbated. In addition to wanting to protect the value of their homes, the older cohort would want to protect social care funding streams. It is even conceivable under such a scenario that Whitehall departments linked to social care, particularly the Department of Health, would lobby against policy interventions to improve affordability of home ownership to younger cohorts. Were a future government to take truly decisive action to bring down house prices in order to help younger generations, older people and their interest groups may lobby against such a move in order to protect social care funding streams.

In this way, by closely linking revenues for social care to continued buoyant house prices, an IHT for care potentially creates incoherence in public policy objectives.

Key points:

- The advantages of an IHT for care and support include: simplicity and communicability; potentially sufficient new revenue; intergenerational fairness; progressivity; scalability of existing probate system; scope to bring the housing wealth of the older cohort into the long-term care funding system; effective use of household resources; and, a potentially universal solution.
- The disadvantages of an IHT for care and support comprise: weak political acceptability; the totemic nature of IHT; the so-called 'Carer penalty' posed by an IHT; the likely behavioural response by households of transferring wealth to lower IHT bills; affordability of IHT bills; the 'lumpiness' of IHT as a revenue stream; sensitivity to fluctuations in house prices; political-risk; long-term sustainability; and potential for policy incoherence with measures to improve the affordability of home-ownership for younger cohorts.

4. Variations

One variation of the IHT model would be for the revenue generated to be allocated to a social insurance fund...

The previous chapter examined the key advantages and disadvantages of implementing a new inheritance tax to fund universal free care and support in England and Wales.

Building on this analysis, this chapter explores some variations of this model that address some of the issues identified.

Exemptions for recipients of informal care

As described above, a universal IHT for care would potentially impose a 'carer penalty', if the estates of individuals who relied only on informal care, and did not impose any cost on the state, were nevertheless liable for an IHT for care. Many family carers might regard such a scenario as highly unfair given the costs they have saved the state.

One response might be to exempt the estates of individuals who receive informal care from liability for an IHT for care. Alternatively, using data from benefit claims and local authority needs-assessments, the IHT bill applied to the estate of those who received informal care could be reduced by an amount proportionate to the equivalent monetary value of the informal care they received.

More generally, if an IHT for care were used to fund low-level universal 'carer-blind' entitlements, in the form of Personal Budgets that could be used to support both the recipient and provider of informal care, then carers may feel that they are receiving 'something back' in relation to the IHT that would be imposed on the estate of the person they care for.[20]

However, any IHT exemptions for recipients of informal care would create an extra administrative burden and reduce the tax base of estates available to fund social care thereby necessitating higher rates of IHT. It would also potentially compel many carers to provide informal care so as to lower the IHT bills for their relatives – effectively mirroring the outcomes observable in the current means-tested system, which an IHT for care would be seeking to prevent.

IHT for care contributions to a social insurance fund

The previous chapter highlighted the political-risk associated with an IHT for care, i.e. that following its implementation, political consensus may change, and the revenue for an IHT for care could subsequently be diverted to pay for other items of public expenditure, particularly in the context of the growing welfare cost of an ageing population associated with the State Pension and NHS.

One solution to this problem might be for the government to create a social insurance fund that would operate at arms-length from the Exchequer from which it would be simply illegal for a government to divert revenue to fund other areas of public expenditure. In effect, this would represent a far stronger ring-fence on social care funding stream than could be provided through any form of taxation, as well having a useful presentational feature: politicians could argue that contributions into an insurance fund do not represent a tax. As noted by commentators, such a fund could subsequently become a vehicle to receive payments from individuals still alive, including working-age contributions.[21] Since it would not be built around a tax, but rather, collective contributions to an insurance fund, any breach of IHT rules by families to reduce exposure may also be much less socially acceptable. Interestingly, a number of countries have deployed independent insurance funds for long-term care, notably Japan, the Netherlands and Germany.

Another variation would be a flat-rate 'charge' on estates rather than a tax, although a flat-rate charge would undermine the rationale for a funding model built around payments from estates...

An estate charge to fund care and support

The imposition of a tax on estates to fund care and support – for example, of 13% - potentially creates a number of complex problems around household behaviour in response to an IHT, investment-risk and policy coherence with measures to improve affordability of housing.

A solution to these problems would be to opt instead for a flat-rate 'charge' on estates, rather than a tax. A charge could have a first claim on an estate, or involve an exempt threshold, to ensure that individuals with extremely modest estates would be able to pass on wealth to family members. For example, the second £20,000 of an estate above a £20,000 exempt threshold could comprise an IHT charge to fund care and support. This would solve several problems associated with deploying a tax on estates to fund care:

- Social care revenue streams would not be over-exposed to investment-risk arising from potential fluctuations in property prices – only a small number of households would see their property dip in and out of liability for such a charge. Indeed, the number of estates in 2007-8 comprising residential property with a value between £25,000 - £50,000 was 1,531 – around 0.009% of total estates containing residential property.[22]
- Incentives for families to move wealth around in order to lower their liabilities to an IHT would be substantially reduced for many households – average families would have to engage in significant and complex wealth transfers worth hundreds of thousands of pounds before they would be able to reduce the amount that they would have to pay as a charge. The number of estates in the £40,000-£60,000 bracket in 2007-8 was 12,130 - around 4% of the total. Around 85% of estates in that year were worth more than £40,000. Around 50% of estates in that year were worth £100,000 - £300,000.[23]
- Social care funding policy would be coherent with attempts to improve affordability of housing – few households would see the 'IHT charge' on their estate affected by falling house prices, and there would no motivation among social care stakeholders to oppose efforts to improve the affordability of housing.

Nevertheless, a flat rate charge would be less progressive than an IHT: wealthier individuals would pay substantially less as a proportion of their estate than less wealthy households. The option of a flat-rate charge on estates also creates the question of what would be the rationale for compelling individuals to pay this charge on death, rather than giving individuals the flexibility and choice to pay it when they were still alive.[24] If effect, adopting a flat-rate charge model undermines the whole rationale for imposing payments on from estates.

Finally, an interesting variant on the flat-rate charge would be to mandate a charge to be paid on the estates of men and women, equivalent to pay the mean average lifetime cost of care for a person age 65 at the start of retirement, which is £22,300 for a man and £40,400 for a woman,[25] and is broadly equal to what an equivalent insurance would have cost anyway. As a form of compulsory insurance, this neatly sidesteps the usual criticism levelled at gender-specific premiums – that it is unfair to discriminate against women – since individuals are no longer alive to feel the effect of the discrimination.

Key points:

- Potential variations of an IHT for care include: exemptions for recipients of informal care; IHT contributions to a social insurance fund; and, the use of an estate-charge, rather than a tax, to fund care and support.

5. Conclusion

Despite the attention it has received in debate on long-term care funding, the analysis presented here suggests there are complex arguments for and against an IHT for care and support...

The debate on how to fund long-term care has evolved dramatically in recent years. Ahead of the 2010 general election, many stakeholders, including some senior politicians, avowed that an "inheritance tax to pay for care" was the best solution to the social care funding challenge.

An IHT for care has repeatedly been described as a quick, simple, feasible solution to the long-term care funding problem, with only politicians, fearful of a negative public reaction, cited as preventing its implementation.

However, the analysis presented here suggests this picture is more complex. Perhaps the single biggest drawback to an IHT for care is that policymakers simply have no real idea as to how much UK households and families would responds to a new IHT by transferring their assets in order to cut their liabilities – and effective contributions - in relation to a new IHT framework. This casts severe uncertainty regarding what revenue for social care would actually be achieved by a new IHT. In this sense, a new IHT for care would represent a 'leap in the dark'.

The 'carer penalty' issue would be likely to emerge quickly following the implementation of an IHT for care. Many informal carers internalise the negative burden of providing care, even as the person they provide care to would in fact be entitled to free support from the state.

Social care funding streams would also be left at the mercy of the irrational, unpredictable UK housing market with social care stakeholders left in fear of a house price crash, which, ironically, some policymakers would actually see as a desirable outcome for the younger generation.

As policymakers and politicians have repeatedly found, there is no 'magic-bullet' in the debate on the future funding of long-term care. Trade-offs are necessary and no 'perfect' solution is possible. The debate is less about different models – all of which would achieve roughly "what it says on the tin" – as much as different conceptions of the problem. Inheritance tax may be one mechanism to lever into the social care system new revenue potentially sufficient to enable the abolishment of means-testing, but it is not the only one. The analysis provided here suggests that an IHT for care and support needs to be carefully weighed up against alternatives.

Appendix: IHT receipts, past and future

The figures below show historic and projected receipts to the Exchequer from IHT, although it should be noted that the IHT framework has itself changed over this period.

2003-2010
£billion in net cash receipts
Source: HMRC

2010-2014
£billion in projected net cash receipts
Source: Budget 2010/Office for Budget Responsibility

Year	**2003-04**	**2004-05**	**2005-06**	**2006-07**	**2007-08**	**2008-09**
	2.50	2.92	3.25	3.54	3.82	2.83

Year	**2009-10**	**2010-11**	**2011-12**	**2012-13**	**2013-14**
	2.38	2.2	2.3	2.4	2.6

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