Commission on Taxation & Welfare
An Coimisiún um Chánachas ⁊ Leas

Briefing Paper

Commentary regarding taxing asset transfers on a death

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Commentary regarding taxing asset transfers on a death

This paper provides extracts from the commentary referenced in the progress paper *Capital taxes recommendations* circulated on 20 May 2022.

1. The 1982-86 Commission on Taxation

First Report of the Commission on Taxation, Direct Taxation, July 1982
Chapter 13 (page 106 of PDF) https://fiscal.ie/app/uploads/2015/10/First-Report-July-1982.pdf

Recommendation: Death should be treated as a disposal of assets for capital gains tax purposes.

Extract from report
The Definition of Disposal

13.43 The question arises whether every change of ownership should count as a disposal and thus an occasion on which capital gains tax may be charged. The major methods by which ownership of an asset is given up are by sale, by gift, by exchange, by settlement on trustees and by dying. Every criterion of a good tax system requires that all of these be treated as an occasion of disposal. At present, under the Irish capital gains tax legislation, all of the above mentioned occasions are treated as disposals except for death.

13.44 Under the 1975 Act, change of ownership by bequest was treated as if there had been no change in ownership. The bequest was not treated as a disposal, but the inheritance was treated as an acquisition: the acquisition price being the value of the asset when it was acquired by the deceased. Under the 1978 Act the acquisition price is the value of the asset at the time of death of the deceased.

13.45 Neither of these procedures is easy to justify. Failure to treat death as a disposal breaks the important lifetime equality of accrual and realisation and makes possible an avoidance device whereby an asset may appreciate significantly over several changes of ownership but will attract no capital gains tax liability if it changes hands only on death. The 1975 Act was defective in these respects; the 1978 Act is worse.

13.46 Certain aspects of capital acquisitions tax shows up other defects of this aspect of the capital gains tax. The former contains provisions designed to encourage owners of wealth to dispose of that wealth before they die. But the capital gains tax provisions have the opposite effect since a chargeable gain can arise when the disposal is in the form of a gift but not when it is in the form of a bequest. We recommend that this anomaly be rectified and that death be treated as a disposal for capital gains tax purposes.

13.47 It may be held that to treat death as a disposal for capital gains tax purposes and to charge the remaining assets to inheritance tax in the hands of the recipient constitutes double taxation. We do not accept that this concept of double taxation has any validity. Under our proposals, and indeed under existing legislation, capital assets are financed by savings out of income which have borne tax. Unrealised increases in the real value of capital assets on death must be regarded as income of the deceased in the same way as other receipts. To exempt these increases on death would be to accord favourable treatment to these gains and would discourage persons from disposing of their assets during their lifetimes. In any event, capital gains tax paid on death will be deducted from the value of any assets for gifts and inheritance tax purposes.

2. Mirrlees review

Tax by Design, the final report from the Mirrlees Review, September 2011
Chapters 15 and 20 https://ifs.org.uk/publications/5353

Recommendation

The current UK inheritance tax is unfair in many ways—it fails to tax those who pass on gifts during their lifetime and benefits those who can arrange their affairs to escape taxation at death, while taxing more highly those (usually of more modest means) who cannot arrange their affairs so as to avoid taxation. It is inefficient because it creates many tax-driven behavioural changes and leads to some asset classes, such as agricultural and business assets, being tax favoured for no clear reason except, presumably, the influence of the agricultural and family business lobbies. The different treatments of capital gains realized at death and those realized during working life also lack justification in the context of our broader proposals to reform savings taxation. We do not think that a tax on estates at death is the best way to approach these issues—there is a stronger case, in principle, for a tax on lifetime receipts, taxing transfers received on an ongoing and cumulative basis. There are important administrative and transition challenges to be addressed in bringing such a proposal to fruition. However, as a long-term proposition, the case for moving in this direction is persuasive.

Extract

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

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

In purely practical terms, the current system does not eliminate double taxation or zero taxation. Assets transferred in the seven years before death can still attract both IHT and CGT. Conversely, CGT is forgiven even when estates are below the IHT threshold and so no IHT would be paid anyway.

And the two taxes exempt different asset classes: people's main homes are exempt from CGT, while agricultural property and unquoted businesses are not (though entrepreneur's relief does provide a reduced rate for owner- managed businesses). More fundamentally, the two taxes serve different purposes. CGT is a tax on returns to savings, not on wealth transfers. As Boadway, Chamberlain, and Emmerson (2010, 801) put it, "*the aim of capital gains tax is to ensure that capital gains are treated on a par with other forms of income such as dividends and interest which will already have been taxed as they accrue (and are also then subject to a wealth transfer tax). Wealth transfer taxation has different ends*."

'Double taxation' of wealth that was already taxed as income (or will be taxed as expenditure) is inherent to wealth transfer taxation. The principles discussed in the previous section essentially concerned whether there is a case for such double taxation. Coexistence of CGT with wealth transfer taxation would merely make this double taxation more explicit.

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

If policymakers do not accept the argument for taxing transfers, then they should not tax them: simply abolish inheritance tax. But if there is an argument for taxing transfers, that must be on top of the regime for taxing returns to capital.

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

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

3. OECD

Inheritance Taxation in OECD Countries, May 2021
Chapters 3 and 4, https://www.oecd.org/tax/tax-policy/inheritance-taxation-in-oecd-countries-e2879a7d-en.htm

Recommendation

4.2.9. Tax treatment of unrealised capital gains at death

The step-up in basis should be reconsidered, particularly where inheritance or estate taxes are not levied, or where inheritance or estate tax exemption thresholds are very high. Under the step-up in basis, which a number of countries provide for, the cost basis of the assets transferred at death is "stepped up" for capital gains tax purposes to their fair market value at the time of the bequest. When the heir sells the asset, only the capital gains accrued since they received the inheritance are subject to capital gains taxes. The step-up in basis allows taxpayers to reduce their total tax liability by passing on their wealth in the form of unrealised gains, and these gains will go fully untaxed where there is no inheritance or estate tax. In addition to generating distortive lock-in effects, this may have significant distributional implications, as unrealised capital gains make up a large portion of the richest taxpayers' wealth. Thus, there is a strong case for removing the step-up in basis for unrealised capital gains at death, especially where inheritance taxes are not levied. Unrealised capital gains may also largely escape any form of taxation where the inheritance or estate tax threshold is very high. In such cases, countries should either reconsider the step-up in basis or lower the inheritance or estate tax exemption threshold. The step-up in basis also creates distortions where an inheritance or estate tax is levied because it still discourages people from realising capital gains. Indeed, if taxpayers sell appreciated property while alive, the gains are subject to capital gains tax, and if they transfer the proceeds of the sale (reduced by the income tax paid) to their heirs when they die, the inheritance or estate tax will also be levied. The step-up in basis therefore creates inequity between taxpayers who realise gains during their lifetime and those who transfer wealth in the form of unrealised gains at death.

The most equitable and efficient alternative to the step-up in basis may be to tax unrealised gains at death but allow for some flexibility in terms of payment arrangements, such as deferral, where necessary. Levying capital gains taxes and inheritance taxes on the same event could result in high tax burdens. In addition, even where the donor bears the capital gains tax and the recipient pays the inheritance tax, it may still be perceived as double taxation. An alternative may be to carry over the accrued gain on transferred assets (whether through in-life gifts or bequests) to the recipients. This would mean that the capital gains accrued during the donor's lifetime would eventually be subject to tax when recipients sell the assets, but would avoid the concomitant levy of the capital gains tax and the inheritance or estate tax. A downside would be that it would require recipients to track the original cost basis of the donor, although this may become less difficult with digitalisation. Another more significant issue is that the capital gains tax liability might become disproportionately large, in particular for businesses and farms that continue operating for several generations, and provide significant lock-in incentives. Thus, the most appropriate approach may be to tax unrealised gains at death, but allow for some flexibility in payment arrangements (i.e. deferral) where demonstrably necessary.

Extract

3.12. Tax treatment of unrealised capital gains at death

3.12.1. Most countries that levy inheritance or estate taxes do not tax unrealised capital gains at death

Three broad approaches apply to the transfer of assets with unrealised capital gains.

- First, countries may consider that when assets are transferred, either as a gift or as a bequest, a capital gain is realised. In this transfer-as-realisation basis, capital gains taxes will apply to non-exempt assets.
- Second, countries may pass the liability for unrealised capital gains to the beneficiary, known as the carry-over basis. In this case, capital gains taxes are levied only when the beneficiary sells the asset, but are levied on the total increase in value since the donor acquired the asset.
- Third, assets may be stepped-up to market value when assets are transferred as a gift or at death. Under the step-up in basis, the capital gain that accrues to the donor is not subject to capital gains taxes and the heir acquires the asset at market value. When the heir sells the asset, only the capital gains accrued since they received the inheritance or gift are subject to capital gains taxes.

  This section does not consider ordinary exemptions, such as those applying to certain asset classes, low-value capital gains, or capital gains on long-held assets.

The step-up in basis is the most common approach among countries that levy inheritance, estate, and gift taxes (Table 3.12). The step-up in basis is the most common approach in countries that levy inheritance, estate, and gift taxes, applied in 12 countries, followed by the carry-over basis in eight countries, and the transfer-as-realisation basis in two countries. Three countries apply different rules depending on the assets received. The transfer-as-realisation approach applies to most assets in Denmark (except artwork, jewellery, vehicles, and household goods, which are taxed on the step-up in basis and family-owned businesses, which are taxed on the carry-over basis) and Hungary (except intangible property, which is taxed under the step-up in basis). The step-up in basis applies to all assets in Finland, except to business property, where the carry-over basis is partially applied.

The carry-over basis is the most common approach for countries that do not levy inheritance or estate taxes. In countries that do not levy an inheritance or estate tax, the carry-over basis is the most common approach for unrealised capital gains, applied in seven countries. The step-up in basis applies in Latvia, while Canada is the only country that applies the transfer-as-realisation approach, levying capital gains taxes upon the donor's death.

The tax treatment of unrealised capital gains may depend on whether assets were transferred as a gift or inheritance. A few countries apply a more favourable tax treatment to inherited assets with unrealised capital gains than to gifted assets. For example, the United Kingdom and the United States apply the step-up in basis to unrealised capital gains at death, but the United Kingdom taxes unrealised capital gains when gifted and the United States applies the carry-over basis to gifts. Inconsistent interactions between inheritance, estate, and gift taxes and capital gains taxes can distort behaviour and give rise to incoherent outcomes.

Table 3.12. **Treatment of unrealised capital gains at death**

	Countries where treatment applies to most assets	
	Country levies inheritance or estate taxes	**Country does not levy inheritance or estate taxes**
Unrealised capital gains are taxed at death	Denmark, Hungary	Canada
Unrealised capital gains pass to heirs on a carry-over basis	Denmark, Finland, Germany, Ireland, Italy, Japan, Luxembourg, Switzerland,	Australia, Austria, Estonia, Israel, Mexico, Norway, Sweden
Unrealised capital gains are exempt upon death and transferred with a step-up in basis	Chile[1], Denmark, Finland, France, Hungary, Korea, Lithuania, Portugal, Slovenia, Spain, United Kingdom, United States	Latvia[2]

← 1. This is considered a non-taxed event, not an exemption.

← 2. Taxes gifts through personal income taxes, does not levy a separate gift tax or an inheritance tax.

Note: Countries may appear multiple times in the table if different treatment applies to different assets. Missing information from Poland and, the Slovak Republic. This table does not consider ordinary exemptions for certain asset classes, low-value capital gains, or capital gains on long-held assets. There is no capital gains tax in Belgium, Greece, and the Netherlands (levy inheritance or estate taxes) or in Czech Republic and New Zealand (do not levy inheritance or estate taxes). There is no capital gains tax on privately held movable property in Switzerland, except when individuals are judged to be traders.

Source: OECD Questionnaire on Inheritance, Estate, and Gift Taxes.

3.12.2. Allowing unrealised capital gains at death to partially or fully escape taxation reduces equity and efficiency

The step-up in basis creates significant distortions and avoidance opportunities, particularly where inheritance or estate taxes are not levied, or where inheritance or estate tax exemption thresholds are very high (Table 3.13). The step-up in basis allows taxpayers to reduce their total tax liability by passing on their wealth in the form of unrealised gains, and these gains will go fully untaxed where there is no inheritance or estate tax. In addition to generating distortive lock-in effects, this may have significant distributional implications, as unrealised capital gains make up a large portion of the richest taxpayers' wealth. The step-up in basis also creates distortions where an inheritance or estate tax is levied because it discourages people from realising capital gains. Indeed, a taxpayer that sells appreciated property while alive may pay capital gains taxes, and then, if they transfer the net proceeds of the sale to their heirs when they die, they will also pay inheritance or estate taxes. The step-up in basis therefore creates horizontal inequity between taxpayers who realise gains during their lifetime and those who transfer wealth in the form of unrealised gains at death. Thus, there is a strong case for removing the step-up in basis for unrealised capital gains at death, especially where inheritance taxes are not levied. Unrealised capital gains may also very largely escape any form of taxation where the inheritance or estate tax threshold is very high. In such cases, countries could either reconsider the step-up in basis or lower the inheritance or estate tax exemption threshold.

Taxing unrealised gains at death may be the most efficient and equitable approach, especially where some payment flexibility is provided, such as deferral, in cases where this is demonstrably necessary. Compared to the step-up in basis, the carry-over basis reduces distortions by taxing unrealised capital gains when heirs sell the assets. This ensures taxpayers have the necessary liquidity when capital gains taxes are due, however, as this allows heirs to postpone liability for capital gains taxes until realisation, taxpayers may defer liability for an indefinite and potentially long period. Lock-in effects may be strong if there is a large tax liability due to long deferral of capital gains taxes. The carry-over basis would also require recipients to track the original cost basis of the donor, although this may become less difficult with digitalisation. On the other hand, taxing capital gains upon the donor's death ensures that gains made during the donor's life are taxed, preventing taxpayers from deferring capital gains taxes indefinitely or avoiding them altogether by holding assets until death. However, this may create liquidity problems for beneficiaries who could be forced to sell assets to pay capital gains taxes. In addition, taxing both capital gains and inheritances upon death may generate a high tax burden. Overall, levying capital gains and inheritances at death at reasonable tax rates, combined with deferral options when payment of tax may create hardships, may address some of the difficulties associated with existing approaches to taxing unrealised capital gains.

Countries should apply consistent tax treatment to gifted and bequeathed unrealised capital gains. Applying more favourable treatment to inherited unrealised capital gains, compared to gifted unrealised capital gains, incentivises taxpayers to retain assets until their death. There is no clear justification for differing treatment between inheritances and gifts, and the inconsistent treatment creates avoidance opportunities and unfair outcomes. These distortions could also have wider economic impacts, as taxpayers could retain underperforming assets to benefit from the capital gains uplift at death (step-up in basis).

Table 3.13. **Defining and assessing capital gains tax treatment at death**

	Transfer-as-realisation basis	Carry-over basis	Step-up in basis
Definition	A capital gain is realised upon death and non-exempt assets are taxed	Liability passes to the beneficiary; gains since the donor acquired the asset are taxed when beneficiary disposes of the asset	Assets are stepped-up to market value and the capital gains that have accrued since the donor acquired the asset are exempt
Advantages	• Ensures capital gains are taxed • Removes tax incentive to hold assets until death or defer realisation	• Ensures capital gains are taxed • Liability occurs when taxpayers have liquidity	• Prevents liquidity issues
Disadvantages	• Liquidity issues • Potential for high tax burden (capital gains taxes + wealth transfer taxes)	• Heirs may postpone realisation indefinitely • Bookkeeping	• Avoidance opportunities • Lock-in effects • Negative distributional effects