

Mr. Tutty to see. *[Signature]*

Minister from Donal McNally

**Subject: Changes to the Capital Acquisition Tax regime in the next Budget/2000 Finance Bill.**

Possible changes to CAT Code.

1. (a) You may wish to announce in the forthcoming Budget your intention to include provisions in the 2000 Finance Bill to exempt the family home completely from Capital Acquisition Tax (CAT) subject to a residential condition for the beneficiary. This would be done in a way that would cover relationships that are not based on marriage, including same sex unions, as well as nieces, nephews, siblings etc residing/have resided with the disponer of the property for a specified period. The change would apply to inheritances (and gifts) taken on or after Budget day.<sup>1</sup>

Revenue tentatively estimate the cost of this measure at £3 million pa.

- (b) You may also wish to propose a widening of the bands for the charging of taxation as well as rationalising the rate structure. This would be on the following basis.

Existing Bands/Rates	Proposed Bands/Rates
Threshold Amount - Nil	Threshold - Nil
Next £10,000 - 20%	Next £40,000 - 20%
Next £30,000 - 30%	Balance - 40%
Balance - 40%	

The cost of this is tentatively estimated by Revenue at £10.5m pa.

Therefore, the total cost involved in making the proposed changes would be £13m pa.

Background.

2. During the debate on the 1999 Finance Bill, and in answer to PQs, you have indicated that you intend to make considerable changes to the Capital Acquisition Tax (CAT) regime in the forthcoming Budget and Finance Bill. (The structure of the current CAT regime is set out in Appendix 1.)

The expected yield for CAT in 1999 is £149 million of which £106 million comes from Inheritance Tax and £8 million from gift tax.

3. The major issues on CAT are:

- CAT on the "family home". There are demands that the family home be exempted in full or substantially relieved from CAT arising on inheritance particularly in the case of certain classes of beneficiaries sharing a family home such as cohabiting couples; elderly brothers and sisters; aunts and nieces; and couples in same sex relationships,

<sup>1</sup> Revenue have suggested excluding gifts to counter possible avoidance. However, the CAT system incentivises inter-vivos transfers so excluding gifts would be contrary to the general approach. — *abolished FB 2000*

where, in all cases, the amount of CAT payable on the shared domestic residence can be substantial.

- The low rate of increase (indexed to CPI since 1990) in CAT thresholds when compared to house price inflation, particularly in the Dublin area.
- The low level of thresholds in absolute terms in respect of particular gifts and inheritances taken by close relatives (other than children) and strangers i.e. £25,720 and £12,860 respectively.

Essentially the issue concerns (i) the low thresholds, relative to present day house values especially in Dublin, which is resulting in children (and other beneficiaries) having to pay substantial CAT when they inherit the family home and (ii) in the context of the family home, the need for the CAT law to take account of other non-marital traditional and contemporary relationship types. These factors warrant a review of the CAT arrangements. Significant numbers of representations have been made to you on the matter.

In addition there is also need to examine the bands for charging the tax (in excess of the thresholds) as well as the rates of the tax to take account of the recent inflation in property prices.

4. However, in examining the CAT issue it is important not to lose sight of the over arching goal of equity within the taxation system as a whole. While some updating of the CAT system is appropriate at this stage, significant concessions to those who have been gifted or inherit wealth may reduce the level of equity within the overall taxation system particularly for those paying 46% income tax on relatively low incomes.
5. The proposed exemption in respect of the family home would largely be on the same basis as the existing elderly sibling relief i.e.
  - Minimum period of 5 years during which the disponent and the beneficiary resided together in the house owned by the disponent,
  - The beneficiary not to have an interest in any other residence.

In addition, it seems appropriate to require that the beneficiary in these circumstances should not dispose of the family home for 6 years after the inheritance or gift. Special arrangements would also be made to cover situations where the house is held in trust, discretionary or otherwise.

6. By exempting the family home from CAT much of the emotion that has built up on this particular issue should be largely reduced. The intention is that an individual could not become liable to CAT through inheritance of his principal private residence. Furthermore, a solution based around the disponent and the beneficiary residing/having resided together, should help to resolve the difficulties arising with non-marital or same sex relationships (as well as aunts/nieces etc residing together). It would also ensure that the tax code would be neutral in relation to certain types of relationships, which are not based on marriage, ahead of developments in the general law on marriage. This approach should help avoid problems which might arise with respect to the Income Tax code if the CAT code were to put such relationships on the same basis as married relationships.

7. The Revenue Commissioners have suggested a ceiling of £500,000 on the CAT relief for the family home since some very large and expensive properties could be bequeathed free of any CAT and this might be open to criticism as unnecessarily generous. However, we feel that it would not be appropriate to establish a new parameter within the system. Such a ceiling might quite quickly come under pressure due to inflation in property prices. Given that the total cost of exempting the family home completely from CAT is just £3m pa it is unlikely that a £500,000 ceiling would generate significant extra revenue for the Exchequer at present.

Rate and Band Changes

8. The rate and band changes are put forward as a simplification measure and as a reduction in CAT paid on the first £40,000 inheritance above the thresholds. It would seem preferable to keep a progressive rate structure in CAT, in view of the considerable wealth that can be passed on from one person to another. It might be regarded as unacceptable that income be subject to progressive tax rates, while wealth, which is far more valuable would not be. At present, a single person earning less than the average industrial wage pays a marginal income tax rate of 46%. The suggested 20%/40% rates mirror the general 20%/40% income tax rate structure which Government policy is aiming for.
9. There is also the issue of the CAT thresholds which apply before CAT is levied. These thresholds are:

	Original 1975	Currently	If indexed from 1975
Class I (Parent/Child)	£150,000	£192,900	£947,000
Class II (Brother/Sister, Aunt/Niece)	£10,000	£25,720	£126,000
Class III (Strangers, cousins etc.)	£5,000.00	£12,860	£63,000

The thresholds have been indexed to the CPI since 1990 only. If they were indexed back to 1975, the CAT yield would disappear. Over 60% of CAT comes from Class II recipients. Even modest increases in the Class II threshold reduce the CAT yield considerably. An increase in the Class II threshold to £50,000, for example, would reduce the CAT yield by half. In the normal course the CAT thresholds will increase by 1% to 2% in 2000 due to indexation. To increase them further to, say, £200,000, £30,000 and £15,000 would cost £21m. Such an increase is not recommended.

10. You may wish to review the options in this paper with officials in the run up to the budget.



1 November 1999

## Appendix 1

### Present CAT Structure

Capital Acquisitions Tax is levied on the recipient of gifts and inheritances. Transfers between spouses, however, are exempted from CAT. The tax is charged on the value of the gift or inheritance in excess of the relevant exempt threshold. There are three exempt thresholds as follows: -

- Class I: £192,900 - where the recipient is a child, or minor child of a deceased child (i.e. certain grandchildren). This threshold also applies to a parent where he or she takes an absolute inheritance on the death of a child. Stepchildren and legally adopted children are entitled to the £192,900 threshold.
- Class II: £25,720 - where the recipient is a brother, sister, nephew, niece, lineal ancestor or lineal descendent (other than those covered by Class I).
- Class III: £12,860 - where the recipient does not fall within Classes I or II (i.e. non-lineal relations and strangers).

Since 1990, these thresholds have been indexed to the CPI on a yearly basis.

Where a beneficiary has received previous gifts or inheritances since 2 December, 1988, the value of these benefits must be taken into account for the purposes of determining the current liability to tax.

The rules for computing both gift and inheritance tax are the same, except that gift tax is charged at 75% of the inheritance tax rates. The current rates applying to gifts and inheritances are as follows:

	Gifts	Inheritances
Threshold Amount	Nil	Nil
Next £10,000	15%	20%
Next £30,000	22.5%	30%
Balance	30%	40%

Close relatives such as nephews or nieces who have been resident with the disponent of the inheritance, may avail of the close relatives relief whereby the value of the shared residence may be reduced for tax purposes by 80% or £150,000, whichever is the lesser. Both the disponent and the recipient must have been living in the house for ten continuous years immediately prior to the inheritance and the recipient must not be beneficially entitled to any interest in any other dwelling-house.

A nephew or niece of a disponent is treated as a child of the disponent in respect of a benefit comprising business or farming assets if the nephew or niece has worked

substantially on a full-time basis for the disponer in the 5 years ending on the date of the benefit.

In order to avail of the £192,900 threshold, a nephew or niece must be able to show that the benefit consisted of business or farming assets, or shares in a trading company, and that he or she has worked in the business throughout the relevant 5 year period for more than 24 hours a week (or for more than 15 hours a week where the business concerned is carried on exclusively by the disponer, any spouse of the disponer and the nephew or niece concerned).

### **Aggregation**

Where the beneficiary has received previous gifts or inheritances since 2 December 1988, the value of these benefits is added to the value of the current benefit when determining the CAT liability on the current gift or inheritance. This has on occasions given rise to representations regarding the size of the Class II and Class III thresholds.