The Treasury’s response to proposals for tax simplification

Inheritance tax and trusts | OMB | Personal tax

27 January 2022

The Treasury’s formal response on 30 November to OTS’s reports on inheritance tax and capital gains tax will result in limited tax changes. What is being changed and what major changes have been avoided?

No major changes to inheritance tax and capital gains tax will be flowing from the Office of Tax Simplification (OTS) reports, after the Treasury’s formal response on 30 November. What is being changed and what major changes have been avoided? We are taking stock of all this and what it may mean for clients.

There were four reports by the OTS in all, two on inheritance tax (November 2018 and July 2019) and two on capital gains tax (November 2020 and May 2021), all requested by Chancellors, which require an official response. That came with the announcement on Tax Administration and Maintenance Day, 30 November 2021, from the Financial Secretary to the Treasury (FST), Lucy Frazer QC.

In the end, there is one big process change for inheritance tax. Five technical proposals have been accepted for capital gains tax, but only two have a lot of substance in them. There was also some agreement on some good points made, for further consideration. Whether these *will* be further considered, we must wait to see.

The OTS reports were a mix of some sensible recommendations for technical changes to improve elements of tax that don't work well, especially with the separation and divorce rules, and some fairly radical policy changes that seemed to go rather beyond mere 'simplification'. So what are the main proposals that have not been accepted?

The good news: the major changes that are not being made!

For now at least, no major changes to inheritance tax or capital gains tax proposed by OTS are being implemented by the Treasury/HMRC. This became apparent when the chancellor made no announcements of capital tax changes in the Autumn Budget on 27 October 2021. If any tax increases were to be made, this seemed the moment, when the country was emerging from the ravages of Covid-19 lockdown and ahead of the next election. So, the Treasury announcement confirms this more formally.

The following capital tax areas, suggested by the OTS for reform, are not being changed for now.

Increasing capital gains tax rates to bring them more in line with income tax

After great speculation about increasing capital gains tax rates ahead of the Spring Budget 2021, the chancellor froze allowances for five years; however, the rates have been left at a maximum of 20% (or 28% on residential property) compared with a top 45% rate on income tax. So, it is sensible for clients to continue taking capital gains, using the annual exempt amounts (£12,300 each) where they can, in addition to any tax free gains through ISAs. Some tax planning, such as for gifts that actually trigger some capital gains, may also be worth considering further.

Normal expenditure out of income exemption

This remains intact, and is not being restricted, so it's really worth making the most of this very generous exemption by getting the details right. Two key steps to securing the relief are the written commitment to go on making the payments and the records to show there is surplus income to meet the gifts. Ideally, clients complete the IHT403 form year by year to show their income and expenditure, and that vital surplus.

CGT uplift on death

The OTS included proposals in three of its four reports (the second on inheritance tax and both capital gains tax reports) to cut back what it called a 'double benefit' – where an estate pays both no capital gains tax on death (as there is an 'uplift' to probate values) and no inheritance tax where there is either a full business or farm relief (business property relief or agricultural property relief) or a spouse exemption. So there is no change for now, which may mean that some business or farm owners will continue to put off making gifts to family working hard in the enterprise (see below).

Hybrid businesses: the 'trading threshold' for 100% business property relief

The proposal that this should be increased to 80%, from at least 50%, was not taken up. This is helpful for businesses which have a significant 'investment' element; e.g. with properties let out giving a good rental income, alongside their trading income. These hybrid businesses must satisfy a test that has four elements looked at 'in the round' – capital value, income, turnover and management time – to see if it can be considered mainly a trading business. If it can, you can secure 100% relief, even though only just over half trading, which can be seen as generous. This is not straightforward and specialist advice is recommended on the operation of this practice.

It is important for all such hybrid businesses to 'stand back' from time to time, and look at their accounts from the longer-term perspective, to ensure they are satisfying the test; for example, that they do not have too much cash that might breach the 'excepted assets' rules. While the old cliché still rings true, that you can never have too much cash, you can for inheritance tax purposes. You need to ensure that any cash built up is serving a specific current purpose, or is there for a specific future use, and that is recorded in notes to the accounts or board minutes. This is worth reviewing on a regular basis.

Inheritance tax: major process change for deaths from 1 January 2022

The OTS proposal on inheritance tax already accepted, and indeed now brought into operation, is to simplify the process in many estates where no inheritance tax is being paid.

The HMRC target is that 90% of non tax-paying estates should not have to do an account for inheritance tax, aiming to benefit 240,000 estates a year. Taking effect for estates with deaths from 1 January 2022, the scope of ‘excepted estates’ not required to do a full account (IHT400) is now extended, with the simpler form of account (IHT205) being withdrawn. You will either do the full account or none.

Executors will still need to get full details of the estate, and often proper valuations, to enable them to report the gross and net values when applying for probate, but some work will be saved. This will mainly benefit estates of first spouses to die, but records must still be kept of lifetime gifts, etc. for the second estate. One real benefit of the new rules is that a part nil-rate band can now be transferred to the surviving spouse without the need for a full IHT400, where the late spouse used part of their nil-rate band, e.g. by legacies to grandchildren. The residence nil-rate band, however, still requires a full IHT400 and IHT435 form.

Capital gains tax: extension of ‘no gain, no loss’ separation and divorce rules

The current capital gains tax position on separation and divorce remains difficult, with the loss of the ‘no gain, no loss’ relief after the year of separation. The OTS proposed to extend the ‘no gain, no loss’ window on separation to the later of:

- the end of the tax year at least two years after the separation event; or
- any reasonable time set for the transfer of assets in accordance with a financial agreement approved by a court or equivalent processes in Scotland.

The good news is that the government agrees the window should be extended and will consult on the detail over the course of the next year. This is sensible, and we now need HMRC to follow through and enact change without delay to save more couples suffering unnecessarily. It is not any form of tax avoidance. Other than this, the other technical capital gains tax recommendations accepted were:

- the extension of the payment of capital gains tax on residential property to 60 days (from 30 days), which was very sensible and widely pressed for by the professional bodies; and already implemented from October 2021; and
- the expansion of the specific rollover relief rules which apply where land and buildings are acquired under compulsory purchase orders.

There were also two HMRC process issues:

- the need for improvement to guidance: HMRC has reviewed and expanded the guidance on the UK property tax return, which was published and updated on 24 January 2022 (see bit.ly/3IEJ0cv) and ‘will proceed to the other areas of guidance listed in due course’; and
- the integration of the different ways of reporting and paying capital gains tax into the Single Customer Account, making it a central hub for reporting and storing capital gains tax data. HMRC will consider this as part of the delivery of the Single Customer Account, the service development of which is a long term HMRC strategy.

Business and farm owners: tax provisions discourage gifting to children

The ‘double benefit’ (as termed by the OTS) referred to above has a practical effect unforeseen by the original announcement that the 100% rate of agricultural property relief and business property relief (when introduced by the then Chancellor) would encourage owners of farms and businesses to pass interests on to the next generation working hard to make it work. This is one of the distortions of the capital tax system, as noted by the All Party Parliamentary Group (APPG) on Intergenerational Fairness in their report on inheritance tax in January 2020, which led them to propose a radical re-working of inheritance tax.

They proposed removing most of the exemptions and reliefs, moving to a much simpler tax with lower rates of 10% and 20%. Whether you agree with their conclusion, they produced some helpful analysis of the problems of a complex tax that often produces unfair or distorted outcomes.

One consequence of the tax discouragement to make lifetime gifts – with advisers regularly encouraging clients to hold on to asset until they die for the ‘double benefit’ in tax terms – is that many of the younger generation continue to work for family enterprises without either a proper remuneration for their hard work and long hours; or any guarantee of their getting proper benefit for building up the equity in the business.

In recent years, we have seen a growing number of proprietary estoppel cases, where claims are made that parents promised one child ‘one day all this will be yours’! When they don’t later inherit it all, but (say) have to share with siblings who have not put in the time and effort, they claim reliance on the promise to their detriment – i.e. they wouldn’t have worked all those hours, for so little pay, without the assurance they would inherit.

This has happened a lot with farms, where the emotional pull of retaining the farm, with all its family history, is often great and the income return also can be limited compared with capital value. These situations are not helped by the continuance of the status quo.

Clients who haven’t been adversely affected by changes to capital tax

There is, then, little change for clients, reassuringly so for those benefiting from the present capital tax regime. The decision to disregard the Wealth Tax Commission report of December 2020, which had suggested that a ‘one-off’ wealth tax would be an option for funding the costs of the Covid-19 crisis, is also a relief.

Lucy Frazer’s Parliamentary written answer on 16 November 2021 pointedly says the Commission was nothing to do with government and said: ‘The government is committed to a fair tax system in which those with the most contribute the most. The UK already taxes assets and wealth across many different economic activities, including the acquisition, holding, transfer and disposal of assets, and income derived from assets.’

The major tax rise of 2021, the health and social care levy, due to take effect in April 2022, leaves many older clients, including many ‘baby boomers’, doing relatively well. The 1.25% is primarily paid by the working population, by both employer and employee, though it will also apply to dividends. Those retired with a decent pension income, and/or property rental income, will pay nothing extra from this income towards health and social care. Many retired clients will also benefit from the status quo that applies to capital and wealth taxation generally.

Many of those who might have anticipated a higher tax burden are therefore now in a position to help their children or grandchildren who are having to meet the higher tax burdens this April, along with the cost of living rises (especially of energy). Now is a great time for clients to review what they have, what they need, and what they could share by gifts in effective lifetime planning.

There is an opportunity for many to help correct the relative generational imbalance between those who have retired after years of tax breaks on pensions and homes, which gives substantial secure capital, and those who have not really had time to build up that capital and are still working hard to meet increasing costs and build up their savings.

John Bunker, then chair of the CIOT Private Client (UK) Committee, led a CIOT team giving evidence in meetings with the OTS on all four OTS reports, which all fell in his three and a half years as chair.